Catholic University Law Review

Volume 60
Issue 4 *Fall 2011*

Article 5

2011

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THE UNLEARNING CURVE: TAX-BASED CONGRESSIONAL REGULATION OF EXECUTIVE COMPENSATION

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It has been said that insanity is "doing the same thing over and over again [and] expecting different results."[1] Thus, when it comes to the regulation of executive compensation through the Internal Revenue Code,[2] one must wonder: is Congress insane?[3] Although this Article does not answer that question directly, it does explore why Congress continues to enact the same

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1. RAJA KHALIDI & SAHAR TAGHDISI-RAD, UNITED NATIONS CONFERENCE ON TRADE & DEV., THE ECONOMIC DIMENSIONS OF PROLONGED OCCUPATION: CONTINUITY AND CHANGE IN ISRAELI POLICY TOWARDS THE PALESTINIAN ECONOMY iii (2009), *available at* http://www.unctad .org/en/docs/gds20092_en.pdf.

2. All section references, unless otherwise stated, are to the Internal Revenue Code of 1986 (Code), as amended, and the regulations promulgated thereunder.

3. Albert Einstein also said that "[t]he hardest thing in the world to understand is the income tax." *Tax Quotes*, IRS.GOV, http://www.irs.gov/newsroom/article/0,,id=110483, 00.html (last updated May 20, 2011). So, perhaps, the answer is that Congress does not fully understand what it is doing.

types of tax penalties on executive compensation when such provisions are ineffective, inefficient, and inequitable.[4]

Early legislative attempts to regulate executive compensation did not take the form of tax rules.[5] Rather, the federal government regulated executive compensation largely through other means, such as mandated disclosures.[6]

4. Meredith R. Conway, *Money for Nothing and the Stocks for Free: Taxing Executive Compensation*, 17 CORNELL J.L. & PUB. POL'Y 383, 410, 417 (2008) (noting the ineffectiveness of §§ 162(m) and 280G); William A. Drennan, *The Pirates Will Party on! The Nonqualified Deferred Compensation Rules Will Not Prevent CEOs from Acting Like Plundering Pirates and Should Be Scuttled*, 33 VT. L. REV. 1, 5 (2008) (arguing that § 409A should be repealed due to ineffectiveness); Jamie Dietrich Hankinson, *Golden Parachute Tax Provisions Fall Flat: Tax Gross-Ups Soften Their Impact to Executives and* Square D *Overinflates Their Coverage*, 34 STETSON L. REV. 767, 783–89 (2005) (demonstrating ways the intended effects of §§ 280G and 4999 can be circumvented); Michael J. Hussey, *Has Congress Stopped Executives From Raiding the Bank? A Critical Analysis of I.R.C. § 409A*, 75 UMKC L. REV. 437, 439 (2006) (concluding "§ 409A does not adequately address the perceived abuses regarding nonqualified deferred compensation"); Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 884 (2007) (concluding that § 162(m) is likely an ineffective provision); Susan J. Stabile, *Is There a Role for Tax Law in Policing Executive Compensation?*, 72 ST. JOHN'S L. REV. 81, 94–100 (1998) (concluding that §§ 162(m) and 280G are ineffective at controlling executive compensation); Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125, 128–29 (2001) (arguing that the golden parachute provisions are not only ineffective but also counterproductive); Edward A. Zelinsky, *Greenmail, Golden Parachutes and the Internal Revenue Code: A Tax Policy Critique of Sections 280G, 4999 and 5881*, 35 VILL. L. REV. 131, 134 (1990) (concluding that §§ 280G and 4999 "embody a serious misuse of the Code" and "have exacerbated the perceived problems at which they are aimed"); Kurt Hartmann, Comment, *The Market for Corporate Confusion: Federal Attempts to Regulate the Market for Corporate Control Through the Federal Tax Code*, 6 DEPAUL BUS. L.J. 159, 178, 180–87 (1993) (examining the deficiencies in using tax penalties to try to regulate the takeover market); Ryan Miske, Note, *Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1680 (2004) (concluding Congress cannot effectively limit executive compensation by using the Code to provide disincentives). Although these scholars agree that tax penalties on executive compensation do not effectively achieve their stated legislative goals, none have yet considered why Congress nevertheless continues to enact such provisions.

5. *See* MARK H. LEFF, THE LIMITS OF SYMBOLIC REFORM: THE NEW DEAL AND TAXATION, 1933–1939 74–90 (1984) (discussing attempts to restrain executive compensation levels in the New Deal era).

6. *Id.* at 76–80. Executive pay arrangements first received public attention in the mid-1930s, during the Great Depression. Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 938–939 (1993); *see also* HARRY G. HENN, HANDBOOK ON THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 487 (2d ed. 1970) (noting post-Depression interest in executive compensation). Then, like now, executives who appeared to be unaffected by or somehow profiting from the economic distress of ordinary Americans were pilloried. *See* LEFF, *supra* note 5, at 74–76. In response, Congress and the administration of President Franklin D. Roosevelt undertook a number of efforts designed to curtail executive compensation levels. *See id.* at 74–90. These efforts fell into two broad categories: mandated disclosures and salary limits for government contractors. *Id.* Some view the sharp increase in marginal tax rates during the 1930s as an attempt to use the Code to regulate executive compensation. *See, e.g.*, Elson, *supra*, at 938–99 (noting that Congress's response to

Since the 1980s, however, each time executive compensation has become an issue of national interest, Congress has enacted tax provisions specifically designed to influence executive compensation practices.[7]

Although each of these tax provisions has a different genesis, focus, and design, they share an important characteristic: each one is a tax penalty provision.[8] As such, they aim to alter corporate and executive behavior by making it more costly to engage in certain compensation practices that Congress has identified as undesirable.[9] In theory, increased costs should deter companies and their executives from engaging in those targeted practices.[10] In reality, many companies and their executives maneuver around these penalties to achieve roughly the same ends that were possible prior to the enactment of these provisions.[11] Many others proceed undeterred by the existence of these penalties.[12]

Part I of this Article introduces these tax penalty provisions. Then, Part II discusses the flaws inherent in using the tax system to try to modify non-tax behavior. Given these weaknesses, Part III considers Congress's continual use of tax penalties to respond to debates over executive compensation. In particular, Part III examines such legislation and finds that it does not serve a meaningful instrumental or expressive function. Part IV concludes that the Code is a poor legislative tool for regulating executive compensation practices—a lesson that Congress has repeatedly failed to learn. If Congress wants to effectively alter corporate and executive behavior, a new strategy is needed. Part IV also briefly evaluates Congress's options in that regard.

I. THE EXECUTIVE COMPENSATION TAX PENALTY PROVISIONS

Tax law is aimed at much more than merely raising revenue. Congress also often strives to influence the non-tax behavior of taxpayers by enacting

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increased executive compensation levels in the 1930s was to raise income tax rates on high-income taxpayers). That legislative response, however, was not limited to affecting executives.

7. *See infra* Part I.A–C (discussing the enactment of §§ 280G and 4999 (1984), § 162(m) (1993), and § 409A (2004)). A question that might arise is whether the 1980s serve as an appropriate reference date. Although § 162(a)(1), which imposes a reasonableness limit on compensation deductions, was enacted long before the 1980s, it has not been used to regulate compensation paid to public company executives. For more information on the function of § 162(a)(1) in this context, see Joy Sabino Mullane, *Incidence and Accidents: Regulation of Executive Compensation Through the Tax Code*, 13 LEWIS & CLARK L. REV. 485, 509–10 n.90 (2009).

8. These tax provisions serve a penal function and are not aimed at measuring a taxpayer's net income or raising revenue. *See infra* Part I.A–C. Here, the targeted conduct is legal, but viewed as undesirable. *See* Eric M. Zolt, *Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343, 346–360 (1989).

9. *See infra* Part I.A–C.

10. *See infra* Part I.A–B.

11. *See infra* Part I.A–C.

12. *See infra* Part I.A–C.

provisions designed to reward taxpayers for engaging in certain seemingly desirable activities and to penalize them for engaging in certain seemingly undesirable activities.[13] Congress rewards and penalizes various activities by affecting the after-tax costs of particular transactions.[14]

To encourage taxpayers to engage in those transactions deemed desirable, Congress enacts provisions that confer "deductions, credits, exclusions, exemptions, deferrals, and preferential rates."[15] These types of provisions operate to reduce the after-tax costs of engaging in certain activities, in theory making those activities more attractive to taxpayers.[16] For example, the Code encourages individual taxpayers to buy homes, rather than rent, by providing a tax deduction for interest paid on a qualifying home mortgage, as well as preferential tax treatment on the profit one might make from selling a home.[17]

To deter taxpayers from entering into transactions deemed undesirable, Congress enacts provisions that alter what would otherwise be the normal operating tax rules in a manner that penalizes the targeted conduct.[18] Such penalty provisions "deny favored tax statuses, impose special taxes, or disallow, limit, or postpone tax credits or deduction," thereby increasing the

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13. *See* Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 705 (1970) (evaluating Congress's use of the tax code to effectuate social policy goals); Zolt, *supra* note 8, at 343–46 (examining tax code provisions that encourage or discourage behavior); *see also* Hartman, *supra* note 4, at 159–60 (exploring the use of tax laws to further social policy); Stabile, *supra* note 4, at 83, 94–100 (discussing the use of the tax code to achieve social policy goals in the area of executive compensation).

14. *See* Mullane, *supra* note 7, at 489.

15. Surrey, *supra* note 13, at 706. *See also* Zolt, *supra* note 8, at 343 ("Congress encourages good conduct by providing special tax statuses, rates, exclusions, deductions, or credits.").

16. Zolt, *supra* note 8, at 343 ("These tax benefits . . . subsidize the favored activity by reducing tax liability.").

17. *See* I.R.C. § 121 (2006) (excluding from income gains resulting from the sale of one's home, subject to certain limitations); I.R.C. § 163 (allowing a deduction for interest on indebtedness, subject to limits); *see also* Dorothy A. Brown, *Shades of the American Dream*, 87 WASH. U. L. REV. 329, 334, 336–39 (2009) (discussing how the tax code encourages taxpayers to purchase homes); Mark Andrew Snider, *The Suburban Advantage: Are the Tax Benefits of Homeownership Defensible?*, 32 N. KY. L. REV. 157, 158–59 (2005) (explaining the tax incentives of homeownership).

18. *See, e.g.*, I.R.C. § 162(m) (denying a deduction for compensation paid to certain employees, to the extent the compensation exceeds $1,000,000 and is not tied to performance); I.R.C. § 280G (denying a deduction for an excess parachute payment); I.R.C. § 409A (imposing additional taxes for deferred compensation in certain circumstances); I.R.C. § 4999 (imposing an additional tax on excess parachute payments). The aforementioned normal operating income tax rules are the

> already existing rules that would apply to determine the tax consequences in the absence of a subsequently enacted rule clearly disallowing that treatment or prescribing different treatment in order to penalize the taxpayer; it is not meant to refer to a comparison of current rules to a normative income tax.

Mullane, *supra* note 7, at 489 n.13 (citing Zolt, *supra* note 8, at 348).

after-tax costs of undesirable activities.[19] In theory, the increased cost will discourage taxpayers from engaging in the conduct.[20]

Over the course of the last few decades, Congress has concluded that several executive compensation practices are undesirable.[21] Congress thus tried to discourage companies and their executives from engaging in those compensation practices and used the Code to do so. Congress first enacted tax provisions in an attempt to discourage companies from offering, and executives from receiving, golden parachute payments above a defined level.[22] Almost a decade later, Congress enacted legislation to deter companies from paying executives more than $1,000,000 unless the compensation was tied to the executive's performance at the company.[23] More recently, Congress sought to discourage certain types of executive deferred compensation terms and benefits.[24] From a superficial standpoint, the provisions enacted to discourage these undesired activities appear very different: they each have a different genesis, focus, and design.[25] However, they all serve a penal function.[26] Accordingly, they attempt to shape or deter behavior by increasing the costs of engaging in the targeted, undesirable activities.[27]

In the executive compensation context, Congress uses two primary deterrence methods: disallowing or limiting a company's ability to take an otherwise allowable deduction for the compensation it pays and imposing additional taxes on the compensation an executive receives.[28] These methods exemplify the inherent limitations in using the tax system as a means to discourage non-tax taxpayer behavior.[29] For instance, sophisticated tax planners are able to shunt their way around many statutory obstacles to achieve the desired results of their clients.[30] More significantly, even if a statutory bypass is unavailable or otherwise unappealing, the Code is limited to influencing non-tax taxpayer behavior because the Code merely provides how certain transactions are to be taxed and thus does not prohibit them.[31] As a result, taxpayers are free to engage in an undesirable activity and incur any

19. *See* Zolt, *supra* note 8, at 344.

20. *Id.*

21. *See, e.g.*, LEFF, *supra* note 5, at 74–90 (discussing attempts to restrain executive compensation levels in the New Deal era); Stabile, *supra* note 4, at 84–93 (detailing more recent efforts to police executive compensation).

22. *See* I.R.C. § 280G; I.R.C. § 4999; *see also infra* Part I.A.

23. *See* I.R.C. § 162(m); *see also infra* Part I.B.

24. *See* I.R.C. § 409A; *see also infra* Part I.C.

25. *Compare* I.R.C. § 4999, *with* I.R.C. § 162(m), *and* I.R.C. § 409A.

26. *See* Zolt, *supra* note 8, at 345–65.

27. *Id.* at 344.

28. *See infra* Part I.A–C.

29. *See* Zolt, *supra* note 8, at 356–60.

30. *See* Drennan, *supra* note 4, at 28.

31. *See* Zolt, *supra* note 8, at 359. The Code does prohibit tax-related behavior, such as engaging in tax fraud. *See, e.g.*, I.R.C. § 7206 (2006).

ensuing tax penalty.[32] Many corporate taxpayers, for example, are largely indifferent to the additional costs that the executive compensation tax penalties impose.[33]

The executive compensation tax penalty provisions suffer from the aforementioned limitations, as well as other defects that render them ineffective in achieving their stated goals.[34] Making the situation appear even bleaker, these provisions also have led to negative, unanticipated consequences.[35] Given these results, it is questionable why Congress continues to enact tax penalties on executive compensation.

A. Targeting Golden Parachute Agreements

Sections 280G and 4999 are tax penalty provisions that were enacted to restrain the size of certain executive severance agreements, referred to as golden parachutes.[36] Starting in the early 1980s, golden parachutes became a very popular component of many executive compensation packages.[37] Congress became concerned about the effect these agreements would have on the business market and shareholders.[38] In particular, Congress was concerned "that sizeable golden parachutes would (1) result in a target's shareholders being paid less for their stock in a takeover, (2) discourage potential buyers, and (3) encourage management to pursue a transaction that was not in the best interest of the shareholders in order to reap the financial rewards of a parachute."[39]

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32. *See* Joy Sabino Mullane, *Tax Penalties on Executive Compensation: Is the Cure Worse than the Disease?*, 6 AM. U. BUS. L. BRIEF 15, 16 (2010) ("[M]any companies willingly incur the penalties imposed on them and absorb the penalties imposed on their executives.").

33. *See infra* Part II.

34. *See infra* Part II (discussing the inherent flaws of tax penalties).

35. *See* Drennan, *supra* note 4, at 4–5.

36. *See* I.R.C. § 280G (2006); I.R.C. § 4999. The golden parachute provisions were Congress's first effort to directly affect executive compensation via tax penalty provisions. *See supra* note 22 and accompanying text. A golden parachute, for tax purposes, "is an agreement to make payments or provide other benefits to an executive if the company experiences a change in ownership, effective control, or the ownership of a substantial portion of its assets." Mullane, *supra* note 7, at 512 n.105 (citing I.R.C. § 280G(b)(2)(A)(i)). *See generally* William R. Spalding, Note, *Golden Parachutes: Executive Employment Contracts*, 40 WASH. & LEE L. REV. 1117, 1117–22 (1983) (explaining the function and operation of golden parachutes); Bill C. Wilson & Diane M. McGowan, *Golden Parachutes*, *in* TAX MGM'T (Bureau of Nat'l Affairs, Portfolio No. 396, 2008).

37. *See* STAFF OF J. COMM. ON TAXATION, 98TH CONG., GEN. EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 199–200 (Comm. Print 1984) [hereinafter DEFRA J. Comm. Print]. The proliferation of golden parachute agreements during the early 1980s was in response to the heightened level of acquisitive activity at that time. *See id.* (explaining that §§ 280G and 4999 were enacted in response to the increasing number of corporate takeovers).

38. *See id.* at 200.

39. *See* Mullane, *supra* note 32, at 15 (citing DEFRA J. Comm. Print, *supra* note 37, at 199); *see also* S. COMM. ON FINANCE, 98TH CONG., DEFICIT REDUCTION ACT OF 1984,

Galvanized by these concerns, Congress enacted §§ 280G and 4999, which are designed to work synergistically to make golden parachutes above a defined level cost-prohibitive.[40] Section 280G does its part by prohibiting companies from taking a deduction for any excess parachute payment it makes to an executive.[41] Section 4999, in turn, imposes a twenty percent tax on any person who receives an excess parachute payment.[42]

An excess parachute payment is present when a golden parachute agreement provides for payments equal to or greater than three times a base amount, which is determined with reference to the executive's average annual taxable compensation.[43] The excess parachute payment is the portion of the golden parachute payment that exceeds the base amount.[44] Thus, so long as the golden parachute limits payments to less than three times the executive's annual compensation, the corporation may deduct any payments made pursuant to the agreement and the executive will not incur penalty taxes.[45] If, however, the agreement provides a payout that exceeds the limit, then the

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EXPLANATION OF PROVISIONS APPROVED BY THE COMM. ON MAR. 21, 1984 195 (Comm. Print 1984) [hereinafter DEFRA S. Comm. Print].

40. *See, e.g.*, Stabile, *supra* note 4, at 91 (commenting that §§ 280G and 4999 were expected "to make excessive parachute payments financially prohibitive" for companies and their executives); *see also* Hankinson, *supra* note 4, at 778 (noting that Congress intended §§ 280G and 4999 to work together to reduce the largesse of golden parachutes). It should be noted that §§ 280G and 4999 only apply to a limited group of individuals, comprised of employees and independent contractors who are also either shareholders, officers, or highly compensated individuals. *See* I.R.C. § 280G(c). A highly compensated individual is defined as one "who is (or would be if the individual were an employee) a member of the group consisting of the highest paid 1 percent of the employees of the corporation or, if less, the highest paid 250 employees of the corporation." *Id.* The targeted group is further limited in that the golden parachute provisions do not apply to payments made by a small business or by a company whose stock is not readily tradable and three-quarters of whose shareholders have approved the payments. *See* I.R.C. § 280G(b)(5). The discussion of the golden parachute provisions does not address the recently enacted rules that apply to employers participating in the Troubled Assets Relief Program (TARP). *See, e.g.*, I.R.C. § 280G(e). *See generally* Janice Kay McClendon, *The Perfect Storm: How Mortgage-Backed Securities, Federal Deregulation, and Corporate Greed Provide a Wake-Up Call for Reforming Executive Compensation*, 12 U. PA. J. BUS. L. 131, 156–72 (2009) (discussing the rules under TARP).

41. *See* I.R.C. § 280G(a).

42. *See* I.R.C. § 4999(a). The company must withhold the twenty percent penalty tax from its payment to the executive. *See* I.R.C. § 4999(c)(1). A deduction for the amount of the penalty tax is also specifically disallowed. *See* I.R.C. § 275(a)(6).

43. I.R.C. § 280G(b)(2)–(3), (d).

44. I.R.C. § 280G(a)–(b), (d); *see* Mullane, *supra* note 7, at 515 n.117 (providing a detailed definition of an excess parachute payment).

45. I.R.C. § 162(a)(1). For purposes of this discussion, it is assumed that the compensation the company seeks to deduct is otherwise considered reasonable compensation within the meaning of I.R.C. § 162(a)(1). It should be noted, though, that § 162(a)(1) is rarely applied to public companies, and when the IRS has attempted to do so, it has been unsuccessful. *See* Mullane, *supra* note 7, at 509, n.90.

company forgoes the ability to take a full deduction for any amounts paid and the executive will owe penalty taxes.[46]

To illustrate, suppose an executive earns, on average, $3,000,000 in taxable compensation each year. The executive also has a golden parachute capped at 2.99 times this base amount. In this case, if and when the parachute opens, the payout will be $8,970,000.[47] Because this payment is within the limits of the golden parachute provisions, the executive will pay only those taxes normally due on compensation and no more.[48] The company will also be able to take a deduction for the payment worth $3,139,500, assuming a thirty-five percent corporate tax rate.[49]

If, on the other hand, the golden parachute payment were set at three times the executive's base amount, then the payout would be $9,000,000.[50] In this situation, §§ 280G and 4999 would take effect to increase the after-tax costs for both the executive and the company.[51] The executive would owe an additional penalty tax of $1,800,000, reducing the parachute payment to $7,200,000, before taxes otherwise normally due are paid.[52] This is clearly less advantageous for the executive than the original payment, which initially appears to be less—$8,970,000 versus $9,000,000—but is not subject to the $1,800,000 penalty tax.[53] The value of the company's deduction would also be reduced to $1,050,000, thereby costing the company $2,089,500 more in the form of a foregone deduction, just to pay the executive an additional face amount of $30,000.[54]

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46. I.R.C. § 280G(a)–(b); I.R.C. § 4999(a).

47. Multiplying $3,000,000 by 2.99 produces this figure. *See* Wolk, *supra* note 4, at 142 (noting the "2.99 times compensation" formula).

48. *See* Mullane, *supra* note 7, at 496, 500 (noting that taxes normally due on compensation would include income and applicable payroll taxes).

49. I.R.C. § 162(a)(1). The value of the deduction is determined by multiplying the payment amount by the corporation's tax rate (i.e., $8,970,000 x 0.35). *See* Mullane, *supra* note 7, at 511 (providing an example assuming a corporate tax rate of forty percent).

50. Multiplying $3,000,000 by three produces this figure. *See* I.R.C. § 280G (noting that a payment equal to or greater than three times the executive's base amount produces an excess parachute payment).

51. *See id.* (disallowing a deduction for an excess parachute payment); I.R.C. § 4999(a) (imposing a twenty percent tax on an excess parachute payment).

52. The $7.2 million figure is derived by multiplying $9,000,000 by twenty percent and subtracting the result from $9,000,000 ($9,000,000-($9,000,000 x .20) = $7,200,000). *See* I.R.C. § 4999 (imposing a twenty percent penalty tax on excess parachute payments and requiring companies to withhold the tax from any such payments made to an executive).

53. *But see* Mullane, *supra* note 7, at 517 (providing examples of how executives may avoid bearing the financial consequences of this penalty tax).

54. In this part of the example, the excess parachute payment, which is the nondeductible portion of the payment, is $6,000,000 (or $9,000,000 less the $3,000,000 base amount). 26 U.S.C § 280G(a) (disallowing a deduction for an excess parachute payment); *see also* H.R. REP. No. 98–861, at 849 (1984), *reprinted in* 1984 U.S.C.C.A.N. 1445, 1537 [hereinafter DEFRA Conference Report] (providing an example demonstrating that only the excess parachute payment is nondeductible and that the base amount remains deductible). Thus, only $3,000,000 of the

In theory, then, both parties to a golden parachute agreement have an incentive to avoid contracting for excess parachute payments. In order to be able to fully deduct payments, companies would want to limit the amount of a golden parachute award to ensure that it is within the boundaries set by § 280G. Correspondingly, an executive would prefer such an agreement in order to receive more money on an after-tax basis than if the initial payout was larger but subject to additional taxes that yield less on an after-tax basis.

To be sure, some companies carefully design their golden parachute agreements to conform to the deductibility parameters set by § 280G. However, this compliance does not necessarily mean that the payout levels of these agreements have been restrained. To begin, the golden parachute provisions likely have had a legitimizing effect on these agreements and have encouraged a minimum, not maximum, payout level of 2.99 times an executive's base amount.[55] Moreover, there are a number of ways to manipulate the base amount that is used to determine the limit imposed by § 280G.[56] For example, a company can choose to pay an executive more on an annual basis in order to raise the level at which § 280G applies.[57] This maneuver neither restrains the size of the golden parachute nor reduces shareholder costs.[58]

In the end, however, many companies choose to purposely forego a deduction in order to offer a golden parachute in excess of the § 280G limit.[59]

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payment is deductible, as compared with the full $8,970,000 in the earlier part of the example. *See id.* The value of the deduction is accordingly $1,050,000 (or $3,000,000 x 0.35), which is $2,089,500 less than the $3,139,500 value of a fully deductible payment of $8,970,000.

55. *See, e.g.*, Richard P. Bress, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955, 963 n.38 (1987). ("[T]ax law may have inadvertently created a floor on parachute benefits by codifying a salary multiple that executives might henceforth point to as a congressionally sanctified standard of reasonableness."); Miske, *supra* note 4, at 1680 ("By codifying a salary multiple, § 280G created a floor on parachute benefits that directors and executives could point to as a congressionally sanctioned standard of reasonableness."); Wolk, *supra* note 4, at 142 ("[I]t has been suggested that the golden parachute provisions legitimized the 2.99 times average annual compensation standard, causing such arrangements to become more common.").

56. *See, e.g.*, Wolk, *supra* note 4, at 142–44 (discussing several ways corporations can manipulate the base amount).

57. *See, e.g.*, Stabile, *supra* note 4, at 92 ("Fear of triggering the loss of deduction and imposition of an excise tax may prompt companies to pay executives more in the form of signing bonuses or increased annual income instead of providing for payments contingent on a change in control.")

58. *See, e.g.*, *id.* (providing an example of such manipulation and noting that although the executive receives the desired compensation in other forms, the company's compensation costs increase).

59. *See Executive Compensation: Backdating to the Future: Hearing Before the S. Comm. on Finance*, 109th Cong. 29–30 (2006) [hereinafter Backdating Hearing] (statement of Steven Balsam, Professor of Accounting, Temple University); Michael E. Murphy, *Attacking the Classified Board of Directors: Shaky Foundations for Shareholder Zeal*, 65 BUS. LAW. 441,

More significantly, many also enter into so-called gross-up agreements, which reimburse executives for the concomitant twenty percent penalty tax incurred under § 4999.[60] These agreements effectively shift the economic burden of the twenty percent penalty tax from the executive to the corporation.[61] For the company, a gross-up agreement can triple the after-tax costs of a golden parachute.[62] For the executive, however, it is as if the penalty never existed in the first place.[63]

The foregoing runs counter to some of the cost considerations that compelled Congress to enact the golden parachute provisions, such as the direct and indirect costs that large golden parachutes may impose on shareholders.[64] The fact, though, that companies can and do continue to offer extremely lucrative golden parachutes impinges on more than Congress's cost considerations.[65] The continued prevalence of excessive golden parachutes also indicates that Congress failed in its attempt to alleviate the anti-competitive effects of such agreements.[66] The tax provisions only impose penalties on excessive payments actually made to and received by executives and thus fail to reach extremely lucrative golden parachutes that were never

469–70 (2010) (describing how the §280G limitation is generally enforced against less senior officers, but is generally ignored for the CEO and other most senior officers).

60. *See* Wolk, *supra* note 4, at 139–40 (noting that such additional payments, referred to as gross-up compensation, are taxable, treated as excess parachute payments, and thus also are nondeductible by the corporation and subject to the twenty percent excise tax, in addition to taxes otherwise normally due on the executive's compensation); *see also* Mullane, *supra* note 7, at 517; Wilson & McGowan, *supra* note 36, at A-38 to -39. Executive pay surveys generally indicate that roughly two-thirds of senior executives are protected by gross-up agreements. *See* Perri Capell, *Terminated? Who Cares? Severance-Pay Packages for CEOs Appear to be Coming Down But Slowly*, WALL ST. J., Apr. 14, 2008, at R4 ("[T]wo-thirds of CEOs and 60% of other named executive officers are entitled to have their severance pay increased to cover the extra taxes [of exceeding limits]."); Joann S. Lublin & Scott Thurm, *Money Rules: Behind Soaring Executive Pay, Decades of Failed Restraints*, WALL ST. J., Oct. 12, 2006, at A1 ("By 2004, 77% of 1,000 public concerns tracked by consulting firm Towers Perrin offered . . . gross-up[s]."). In the current economic and media environment, firms may have cut back on many perks, but are less inclined to eliminate golden parachute gross-up agreements. *See e.g.*, Dana Mattioli, *The CEO Pay Survey: Perks Are Cut Amid Pushback on Pay*, WALL ST. J., Apr. 1, 2010, at B4 (noting a recent trend of corporations eliminating gross-ups for perks while only eliminating a small number of gross-ups for golden parachutes).

61. *See* Mullane, *supra* note 7, at 516–17 (noting how the excise tax shifts from the executive to the corporation).

62. *See id.* at 518–19 (providing an example of how gross-up agreements, in combination with other factors, can triple the after-tax cost of golden parachute payments).

63. Wilson & McGowan, *supra* note 36, at A-39 ("The employee will be in the same economic position as if an excise tax did not exist.").

64. *See* DEFRA J. Comm. Print, *supra* note 37, at 199.

65. *See* Spalding, *supra* note 36, at 1117–20.

66. *See supra* text accompanying notes 38–39.

"opened" by a change in corporate control.[67] The lack of tax repercussions for entering into such agreements allows corporations to offer golden parachutes large enough to have a detrimental effect on acquisitive activity, as Congress feared.[68]

Thus, the tax provisions targeting golden parachutes largely fail to achieve either stated congressional objective: they neither encourage healthy market activity by limiting the largesse of parachute agreements, nor reduce any resultant costs to shareholders.[69] Amendments to the statutes could improve the functionality of these provisions, particularly if the underlying treasury regulations were amended as well.[70] Ultimately, though, any tax-based solution will prove inadequate.[71] The Code cannot prohibit extremely generous golden parachutes; it can only make them more costly.[72] Moreover, the targeted corporate taxpayers are either largely indifferent to those increased costs or simply place greater value on the ability to compensate their executives however they see fit.[73] It follows, then, that tax penalties are

67. *See* I.R.C. § 280G(a), (b)(2)(A) (2006) (limiting the section's applicability to "payments"); Wolk, *supra* note 4, at 128 (noting that the tax provisions have no effect on unrealized payments).

68. *See e.g.*, Wolk, *supra* note 4, at 127–28 ("[A] golden parachute could be used to restrict takeovers and entrench management at the expense of shareholders by making the takeover so expensive that the golden parachute functions as a poison pill. Congress was concerned about this aspect of the problem as well, but note that the parachute provisions do not respond to this concern. They apply only if the takeover actually occurs and the payments are actually made; there is no penalty on golden parachute arrangements that are so generous that they discourage any takeover.").

69. *See supra* notes 39–42 and accompanying text (noting that Congress enacted the tax penalty provisions specifically to address the perceived negative effects on shareholders and market efficiency). The golden parachute provisions have been widely disparaged for the inefficient and costly way in which they fail to achieve Congress's intended objectives. *See* Conway, *supra* note 4, at 417–19 (noting the limited effectiveness of § 280G); Hartmann, *supra* note 4, at 179–81 (arguing that §§ 280G and 4999 discourage potentially beneficial effects of golden parachutes); Stabile, *supra* note 4, at 93 ("[N]either with respect to ordinary compensation nor with respect to compensation contingent on a change in control has the Code proven a very meaningful curb on executive compensation."); Wolk, *supra* note 4, at 181 (arguing for repeal of the golden parachute provisions because they "not only allow[] golden parachutes to flourish, but achieve[] this counter-productive result in a complex and costly fashion"); Zelinsky, *supra* note 4, at 134 (determining, in part, that §§ 280G and 4999 may prove to "have exacerbated the perceived problems at which they are aimed").

70. Wolk, *supra* note 4, at 180–81 (suggesting that at least a few of the flaws of §§ 280G and 4999 could be addressed by amending the statutes and the then-proposed accompanying regulations).

71. *See id.* at 181.

72. *See* Zolt, *supra* note 8, at 353–54 (noting that Congress uses tax penalty provisions, such as the golden parachute statutes, to disincentivize behavior that it is either unable or unwilling to expressly prohibit, by increasing the after-tax cost of the targeted activities).

73. *See* Backdating Hearing, *supra* note 59, at 40 (statement of Steven Balsam, Professor of Accounting, Temple University); Hankinson, *supra* note 4, at 802–03; Mullane, *supra* note 7, at

inherently incapable of controlling excessive golden parachutes or the attendant costs to shareholders.

B. Targeting Annual Compensation

In 1993, almost a decade after the golden parachute provisions were enacted, Congress turned its attention to the annual compensation paid to executives.[74] Pervasive public concerns regarding executive compensation galvanized Congress into action.[75] The aims of the resulting legislation, § 162(m), were two-fold: to curtail the amount of compensation paid to executives and to encourage a stronger connection between executive pay and the executive's performance.[76]

Employing an approach similar to § 280G, § 162(m) prohibits a company from deducting more than $1,000,000 of the annual compensation it pays to top executives.[77] In other words, regardless of the amount paid to the executive, the company's deduction is limited to $1,000,000.[78] There are,

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517 (noting that some companies go so far as to reimburse the executive for any personal income tax penalty incurred).

74. *See* Mullane, *supra* note 7, at 512 (noting that §§ 280G and 4999 were enacted in 1984, but that Congress did not enact § 162(m), targeting executive compensation, until 1993).

75. *See, e.g.*, H.R. REP. NO. 103-111, at 646 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 877 ("Recently, the amount of compensation received by corporate executives has been the subject of scrutiny and criticism."); Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, HARV. BUS. REV., May–June 1992, at 28, 28 (noting that the attention executive compensation received from public officials in the 1990s had not been that intense since the 1930s); Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713, 713 (1995) (recalling that media fixation on executive compensation helped propel that issue to reach "national prominence" in 1991).

76. *See* H.R. REP. NO. 103-111, at 646 ("[E]xcessive compensation will be reduced if the deduction for compensation (other than performance-based compensation) paid to the top executives of publicly held corporations is limited."); Robert M. Halperin, Young K. Kwon & Shelley C. Rhoades-Catanach, *The Impact of Deductibility Limits on Compensation Contracts: A Theoretical Examination*, 23 J. AM. TAX. ASS'N (SUPPLEMENT) 52, 52 (2001) (noting § 162(m) was intended to promote a closer correlation between pay and performance, as well as to disincentivize excessive compensation packages); Stabile, *supra* note 4, at 95–99 (noting that § 162(m) attempts to affect both "the amount [and] type of compensation paid to executives").

77. *See* I.R.C. § 162(m)(1)–(3) (2006). Section 162(m) is not as broad as it might initially appear. First, it only applies to publicly held corporations, defined in § 162(m)(2) as "any corporation issuing any class of common equity securities required to be registered under Section 12 of the Securities Exchange Act of 1934." Second, § 162(m) only applies to the CEO and the three other highest paid officers at the company. *See* I.R.S. Notice 2007-49, 2007-25 I.R.B. 1429 (interpreting § 162(m)(1)–(3)). This Article does not address the recently enacted rules that govern employers participating in TARP. *See* I.R.C. § 162(m)(5) (Supp. III 2009). *See generally* Amy Pocino Kelly & Carrie Rozes, *Executive Compensation and Corporate Governance Standards for TARP Recipients*, 111 J. TAX'N 230 (2009) (discussing the TARP-specific rules in detail).

78. *See* I.R.C. § 162(m)(1). The $1,000,000 limit may be further reduced by the amount of any excess parachute payment that would have been considered compensation within the meaning of § 162(m) if § 280G had not disallowed a deduction. *See* I.R.C. § 162(m)(4)(F).

however, many exceptions to this $1,000,000 limitation, including a significant exception for performance-based compensation.[79]

The tax theory behind § 162(m) is that the deduction limitation would function as a restraint on executive compensation because a company would presumably be unwilling to incur the additional tax costs associated with exceeding the limit.[80] To the extent a company wants to compensate an executive in excess of $1,000,000, § 162(m) encourages companies to link executive pay and performance by excluding performance-based pay from the $1,000,000 deduction cap.[81] The reality is that § 162(m) has not been effective in achieving either of its goals.[82] Much like the golden parachute provisions, § 162(m) legitimized annual compensation payments of $1,000,000, resulting in the perception that $1,000,000 constituted a minimum threshold.[83] Moreover, the exceptions to the $1,000,000 deductibility cap—the performance-based exception in particular—allow properly structured annual executive compensation plans to render the cap "virtually meaningless."[84]

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79. *See* I.R.C. § 162(m)(4)(c). Commissions, qualified retirement plan contributions, and nontaxable fringe benefits are also exempted from the one million dollar deduction limitation. *See* I.R.C. § 162(m)(4).

80. *See* H.R. REP. NO. 103-111, at 646 (indicating the Committee's belief that limiting corporate deductions for executive compensation would discourage excessive pay packages); Zolt, *supra* note 8, at 344 (stating that tax penalties, such as postponed or decreased deductions, increase the cost of associated activities, and thus discourage the taxed behavior).

81. *See* Stabile, *supra* note 4, at 95–96 (noting that Congress intended to affect the "type" of compensation paid to executives); *supra* note 77 and accompanying text.

82. *See* Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 S.M.U. L. REV. 299, 346–47 (2009) (noting that "[t]he stated goals of 162(m) are unrealized"); David I. Walker, *The Challenge of Improving Long-Term Focus of Executive Pay*, 51 B.C. L. REV. 435, 444 (2010) (arguing that § 162(m) has contributed to the abuse of share options as pay); *infra* text accompanying notes 85–95.

83. *See* Backdating Hearing, *supra* note 59, at 24, 272 (testimony of Nell Minow, Editor, The Corporate Library) ("When the tax code was changed to prevent executive compensation of over $1 million to be deducted unless it was tied to performance . . . everyone got a raise to $1 million."); *CEO Compensation in the Post-Enron Era: Hearing Before the S. Comm. on Commerce, Science & Transportation*, 108th Cong. 10 (2003) [hereinafter CEO Compensation Hearing] (statement of Brian J. Hall, Associate Professor, Harvard Business School) ("[T]he pay trend makes it look as if [162(m) was] passed with the intention of accelerating, not curbing, CEO pay increases."); John A. Byrne, *That's Some Pay Cap, Bill*, BUSINESSWEEK, Apr. 25, 1994, *available at* http://www.businessweek.com/archives/1994/b336854.arc.htm ("'President Clinton has created a minimum wage for CEOs,' declares Arnold S. Ross, a New York consultant who designs pay packages for executives. 'A $1 million base salary is now the gold standard.'").

84. *See* Stabile, *supra* note 4, at 88 ("[T]he performance-based compensation exception to the $1 million limit renders section 162(m) virtually meaningless."); *see also* FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 156 (2003) (noting that the performance-based exception to § 162(m) creates "a loophole large enough to fly a private jet through"); Kevin J. Ryan, Note, *Rethinking Section 162(m)'s Limitation on the Deduction of Executive Compensation: A Review of the Commentary*, 15 VA. TAX REV. 371, 372 (1995) (noting that the section's safe harbors essentially vitiate the $1,000,000 deduction limitation).

Not only does the performance-based exception permit an unlimited amount to be deducted, but the threshold requirements to qualify for the exception are also easily satisfied.[85] Although compensation is performance-based only if "payable solely on account of the attainment of one or more performance goals,"[86] Treasury regulations provide that a performance goal does not need to be "based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses."[87] Such a standard does link pay to performance, but it does not necessarily tie pay to competent performance.[88] Thus, an executive need not perform well to reap substantial performance-based pay, which undermines Congress's aims in enacting § 162(m).[89]

The performance-based exception has produced several other effects that also defeat the purpose of the statutory scheme. First, overall compensation

85. *See infra* notes 86–87 and accompanying text. The general rules of § 162(a), which only allow a deduction for reasonable compensation amounts, continue to apply. *See* I.R.C. § 162(a)(1) (2006); Stabile, *supra* note 4, at 83 (stating that § 162(a)(1) apparently grants the IRS "authority to disallow deductions for compensation that is viewed to be unreasonable"). However, § 162(a)(1) is rarely applied to public companies to limit a compensation deduction. Where the IRS has attempted to do so, it has been unsuccessful. *See* Mullane, *supra* note 7, at 509 & n.90.

86. I.R.C. § 162(m)(4)(C).

87. Treas. Reg. § 1.162-27(e)(2)(i) (as amended in 1996). Although not all performance goals qualify under the regulation, the standard is far from strict, which significantly increases the likelihood that the goal will be met. *See id.* (requiring that objective goals be met, but not limiting such goals to include positive performance). It is important to note, though, that the performance goals must be "established by a compensation committee composed of outside directors, approved by shareholders, and certified by the company's compensation committee as having been met." Stabile, *supra* note 4, at 87. Treasury regulations elaborate that a performance goal "must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained." Treas. Reg. § 1.162-27(e)(2)(ii).

88. *See supra* note 87 and accompanying text. This less stringent standard does provide flexibility, allowing companies to reward their executives for steering the company through troubled times. Nevertheless, such a standard also allows executives to receive performance-based pay despite potentially poor performance, undermining one of the purposes for which § 162(m) was enacted. *See supra* notes 76, 87 and accompanying text.

89. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 132–33 (2004) (finding that most executives receive generous compensation even in "cases of spectacular failure"); *see also* Backdating Hearing, *supra* note 59, at 29 (statement of Steven Balsam, Professor of Accounting, Temple University) ("[S]ection 162(m) has, at best, been only marginally effective in reducing executive pay and/or tying pay to performance."); *id.* at 272 (testimony of Nell Minow, Editor, The Corporate Library) ("The data show that the disparity between pay and performance is enormous and growing."); James R. Raborn, *Executive Compensation: Much to Do About...*, 10 HOUS. BUS. & TAX L.J. 262, 269 (2010) ("[Section] 162(m) quickly became a provision that only required 'rearranging the deck chairs' as nearly all taxpayers were able to 'work around it' without substantive impact by setting the performance goal hurdles low and the possible payouts high.").

levels increased to account for the addition of a contingent pay risk premium.[90] Second, performance-based pay often became more lucrative than anticipated due to the way it was typically awarded.[91] Third, the pressure to attain certain performance-based goals to achieve greater compensation is viewed as a significant factor contributing to many of the corporate scandals following the enactment of § 162(m).[92] In sum, § 162(m) is not a significant impediment for companies that wish to reward their executives handsomely.

Other exemptions exist in addition to those explicitly provided by § 162(m). For example, the $1,000,000 limit only applies if the executives are employed with the company on the last day of the taxable year.[93] Compensation payable after the executive's employment has ended does not fall within the ambit of § 162(m).[94] Thus, as a result of § 162(m), many companies have encouraged

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90. *See* Mullane, *supra* note 7, at 524 n.167 ("In theory, an executive receiving all or a portion of his pay based on performance risks receiving little or no pay if the company does not perform as expected. To offset this risk, a premium is added to the amount of compensation paid to the executive if the company performs well, increasing overall compensation above the level that would have been paid absent the presence of performance-based risk."). In the years following § 162(m)'s enactment, overall CEO compensation levels increased dramatically, but the portion of compensation comprising base salary decreased significantly. *See* Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation*, 35 WAKE FOREST L. REV. 123, 146 fig.1, 147 tbl.2 (2000) (displaying that base salaries in 1992 accounted for 44.59% of total CEO compensation, but that figure was reduced to 27.85% by 1998.). The Joint Committee on Taxation recently reported that "[s]tudies have indicated that the deduction limitation may have led to some substitution away from salary compensation toward performance-based compensation, but that growth in overall executive compensation has not been reduced." STAFF OF THE J. COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 2 (Comm. Print 2006) [hereinafter JCT Compensation Report].

91. The stock option grant has become the quintessential performance-based compensation. *See* Murphy, *supra* note 75, at 738; *see also* Mullane, *supra* note 7, at 524 ("This is so because a stock option's value is inherently tied to the performance of the corporation's stock if granted with an exercise price equal to or greater than fair market value at the time of the grant: it is only valuable if the stock price rises."). Stock prices generally began rising around the same time that stock options became a more significant component of an executive's compensation package. *See* Mark A. Sargent, *Lawyers in the Perfect Storm*, 43 WASHBURN L.J. 1, 9 (2003) (discussing how the increased use of stock options as a form of executive compensation in the 1990s caused pay to "balloon wildly"); Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 53 (2003) (noting how the absence of limitations imposed by § 162(m) explains "the explosion in executive option grants in the 1990s"). Thus, the stock market boom inured to the benefit of executives receiving hefty stock option awards.

92. *See, e.g.*, PARTNOY, *supra* note 84, at 156–57; Daniel Gross, *Give That CEO a Pay Raise!*, SLATE (July 16, 2002, 5:21 PM), http://www.slate.com/id/2067952 ("[A]s Alan Greenspan put it today, stock options have 'perversely created incentives to artificially inflate reported earnings in order to keep stock prices high and rising.'").

93. *See* I.R.C. § 162(m)(3) (2006).

94. *Id.*

their executives to accept a significant portion of their compensation on a deferred basis.[95]

The foregoing is certainly not a complete catalogue of § 162(m)'s shortcomings.[96] The discussed examples do show that § 162(m) contains significant deficiencies that undermine its effectiveness. Even if those faults could be rectified by, for example, amending or eliminating the performance-based exception, § 162(m) would still be insufficient due to the simple fact that it is a tax penalty provision.[97] Thus, as was the case with the golden parachute provisions, it does not prevent companies from offering compensation above a defined level or impose a particular payment structure.[98] The Code's only course is to make it more costly for companies to offer compensation outside the parameters set by § 162(m).[99] Such increased costs do not unduly trouble many companies, as they still pay nondeductible compensation despite the many ways to circumvent the § 162(m) limit.[100]

C. *Targeting Nonqualified Deferred Compensation*

Section 409A addresses certain executive deferred compensation practices Congress considered inappropriate.[101] Those practices came to light following the collapse of Enron and other similar corporate scandals during the early

95. *See* Eric D. Chason, *Deferred Compensation Reform: Taxing the Fruit of the Tree in Its Proper Season*, 67 OHIO ST. L.J. 347, 378 (2006) ("[P]ublic companies often require executives to defer any base salary over $1 million."); William A. Drennan, *Enron-Inspired Nonqualified Deferred Compensation Rules: "If You Don't Know Where You're Going, You Might Not Get There.,"* 73 TENN. L. REV. 415, 457 n.216 (2006) ("Commentators point out that the enactment of the '$1 Million Cap' of Section 162(m) encouraged many corporations to adopt deferred compensation plans for their executives earning over $1 million.").

96. Commentators have catalogued a variety of other § 162(m) flaws, including the arbitrariness of the $1,000,000 limit, the lack of inflation index, and the inflexibility as to the circumstances of individual companies. *See* Miske, *supra* note 4, at 1687–88; *see also* Murphy, *supra* note 75, at 738–40; Polsky, *supra* note 4, at 920–25; Stabile, *supra* note 4, at 96–97.

97. Mullane, *supra* note 7, at 526.

98. *Id.*

99. *Id.*

100. *See id.*; *see also* Backdating Hearing, *supra* note 59, at 29–30 (statement of Steven Balsam, Professor of Accounting, Temple University) (describing how research from 2005 indicated that numerous corporations were paying executives in excess of the $1,000,000 cap and that "nearly 40 percent of corporations admitted to forfeiting deductions because of section 162(m)"); Steven Balsam & Qin Jennifer Yin, *Explaining Firm Willingness to Forfeit Tax Deductions Under Internal Revenue Code Section 162(m): The Million-Dollar Cap*, 24 J. ACCT. & PUB. POL'Y 300, 322–23 (2005); Halperin et al., *supra* note 76, at 54 (noting a study from 1999 showed that "45 percent [of 297 firms] chose to forgo tax deductibility by not seeking qualification"). *But see* Polsky, *supra* note 4, at 913 (concluding that under the managerial power model "it would be rare for firms (particularly high-profile ones) to forfeit significant amounts of deductions" because of "the potential negative public response").

101. *See* I.R.C. § 409A (2006).

2000s.[102] The targeted practices involved an executive's ability to secure the funds in a nonqualified deferred compensation (NQDC) plan and to control the timing of receipt of payments from an NQDC plan.[103]

The typical NQDC plan is only available to executives.[104] Under such a plan, a company and an executive agree to defer the company's payment of compensation for the executive's services.[105] A properly structured NQDC plan allows companies to avoid the § 162(m) deduction limit and enables executives to shift income tax consequences to a future year, when the executive may be subject to a lower tax rate.[106] However, to postpone the imposition of income tax, executives must not be allowed to demand the deferred compensation at their whim; they must also bear some measure of risk

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102. *See* Chason, *supra* note 95, at 348–49 ("[E]xecutive pensions became front-page news with the collapse of Enron Corporation."); Drennan, *supra* note 95, at 417–18 (noting that scandals surrounding "Enron, WorldCom, Global Crossing, Tyco, HealthSouth, and others" were met with large amounts of publicity and that such publicity "created an environment conducive to fundamental reforms"); Brian Kopp, *New Rules for Nonqualified Deferred Compensation Plans*, 21 J. COMPENSATION & BENEFITS 5, 5 (2005) ("The Enron debacle triggered a concern that some executive compensation practices were getting out of hand."); Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571, 573 (2007) ("[I]n an attempt to stymie some of the particular abuses uncovered in the Enron fiasco, Congress revised the federal tax laws applicable to executive deferred compensation . . . .").

103. *See* JCT Compensation Report, *supra* note 90, at 2 ("Prior to the enactment of section 409A, the tax treatment of NQDC was governed by general tax principles. Several practices had developed that allowed executives deferral of income inclusion, but inappropriate degrees of security and control over amounts deferred. Section 409A was intended to address these practices."); Chason, *supra* note 95, at 383–84 (explaining that § 409A "was enacted . . . in order to tighten the control and security limitations of prior law."); Drennan, *supra* note 95, at 454 (summarizing the pre-§409A flexibility of NQDC plans, which formerly included more withdrawal trigger events, as well as modified terms and schedules).

104. *See* Chason, *supra* note 95, at 361 ("NQDC is effectively and formally limited to executives and other highly paid employees."); *see also* Yale & Polsky, *supra* note 102, at 575 (explaining that NQDC plans "are maintained for the exclusive benefit of highly remunerated employees").

105. *See* Chason, *supra* note 95, at 348 (providing an illustration of how NQDC plans are formed and taxed).

106. *See supra* notes 93–95 and accompanying text; *see also* Chason, *supra* note 95, at 383 ("First, NQDC gives lower- and middle-level executives an opportunity for income averaging. These are the executives who might expect to be in a lower tax bracket upon retirement. Second, NQDC allows the corporation to avoid the limits of Code § 162(m) . . . ."). Note, however, that a company is prohibited from taking a deduction for NQDC until the executive includes it in income. *See* I.R.C. §§ 83(h), 267(a)(2), 404(a)(1)(B), 404(a)(5). This potential drawback has not stopped companies from compensating their executives with NQDC. *See, e.g.*, STAFF OF THE J. COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 40 (Comm. Print 2003) [hereinafter JCT Enron Report] ("Enron allowed its executives to defer significant amounts of compensation even though Enron had to forego a current deduction with respect to such amounts. The fact that Enron was apparently indifferent to the deferral of its deduction provides further support for the need for changes to the tax treatment of nonqualified deferred compensation.").

that the company will be unable to pay the deferred compensation in the future.[107] Otherwise, the executive would be subject to income tax on the earned compensation even though he or she had not yet received the remuneration.[108]

Since the enactment of § 162(m), NQDC plans have grown in popularity, and NQDC has come to comprise a more significant portion overall of executive compensation packages.[109] It followed, then, that executives wanted some measure of access to the substantial amounts invested in these plans and for those funds to be as secure as possible, all without triggering a tax liability. As a result, certain NQDC plan features were developed to provide some measure of security and access, while also allowing executives to defer income tax consequences until receipt.[110] When the Enron scandal revealed some of these NQDC plan features, Congress responded with § 409A.[111]

Section 409A imposes various rules regarding when and under what circumstances an NQDC plan participant can receive distributions.[112] Failure to comply with these rules subjects the deferred compensation under the NQDC plan to current, rather than deferred, taxation, plus interest.[113] Section 409A also imposes a twenty percent penalty tax on the participant for the noncompliant NQDC, much like § 4999 of the golden parachute provisions.[114]

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107. *See* Chason, *supra* note 95, at 348 ("A promise will not [suffice] if the executive has an unqualified right to demand immediate payment . . . . [T]he executive must have a mere unfunded promise to pay, which would be compromised if the corporation goes bankrupt or becomes insolvent."); Mullane, *supra* note 7, at 500–05 (providing discussion and illustration of those tax rules).

108. *See* Mullane, *supra* note 7, at 505.

109. For example, NQDCs comprised a major part of Enron's executive compensation. JCT Enron Report, *supra* note 106, at 14.

110. *Id.* at 14, 40.

111. Chason, *supra* note 95, at 349 ("Congress responded [to the Enron scandal] with hearings and enacted § 409A of the Internal Revenue Code ("Code") in October 2004 . . . . Much of the debate leading up to Code § 409A focused on Enron (and like scandals) and asked whether the . . . gates to deferral were too wide."); Drennan, *supra* note 4, at 2, 20 (explaining that § 409A was created in response to the Enron crisis, and its legislative history only references the Joint Tax Committee's Enron Compensation Report); Alvin D. Lurie, *Grandpa Still Hiding in Proposed Deferred Compensation Regs*, 109 TAX NOTES 1187, 1189 (2005) (explaining § 409A "was a direct response to the Enron debacle").

112. *See* I.R.C. § 409A(a) (2006).

113. *See* I.R.C. § 409A(a)(1) (including all deferred compensation under the plan unless it is "subject to substantial risk of forfeiture and not previously included in gross income"). The interest rate is one percentage point above the underpayment rate. *See* I.R.C. § 409A(a)(1)(B)(ii).

114. *See* I.R.C. § 409A(a)(1)(B)(i)(II); *see also* I.R.C. § 4999(a) ("There is hereby imposed on any person who receives an excess parachute payment a tax equal to 20 percent of the amount of such payment.").

Though enacted in 2004,[115] § 409A did not go into effect until 2009.[116] It is thus premature to discuss the effects of § 409A. However, some commentators imply that one purpose of § 409A is to restrain overall NQDC levels.[117] That motivation may have been part of post-Enron reform discussions, but there is nothing in § 409A's legislative history mentioning that one of its purposes is to act as an overall restraint.[118] Considering § 409A's design, it seems unlikely that the suppression of overall NQDC levels was an intended aim. The 409A tax penalty is imposed if the NQDC plan does not comport with specified timing rules; it is not imposed on NQDC above a certain level, like the golden parachute provisions (§§ 280G and 4999) or § 162(m).[119]

It could be argued, though, that § 409A's requirements are so onerous as to discourage compensation in the form of NQDC. In that way, § 409A would act as an overall restraint on NQDC amounts. However, it is likely that executive compensation packages would then be adjusted to shift compensation to another form. As a result, overall compensation levels would not be reduced even if NQDC levels were reined in.[120] For example, an executive could push for his or her compensation package to shift from NQDC to current compensation. Such a shift would provide the executive with greater security and access to his or her earned compensation, but it would also be subject to current taxation. That tradeoff could be worthwhile in the post-§409A environment and would be just another rearrangement in the composition of executive pay packages in response to a tax penalty provision.[121] A shift toward more current compensation, however, could reap

115. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885(a), 118 Stat. 1418, 1634–39 (codified as amended at I.R.C. § 409A).

116. I.R.S. Notice 2007-86, 2007-46 I.R.B. 990; I.R.S. Notice 2007-78, 2007-41 I.R.B. 780. The IRS repeatedly issued transition relief delaying the date on which NQDC plans had to comply with § 409A. I.R.S. Notice 2007-86, 2007-46 I.R.B. 990; I.R.S. Notice 2007-78, 2007-41 I.R.B. 780.

117. *See, e.g.*, MICHAEL DORAN, EXECUTIVE COMPENSATION REFORM AND THE LIMITS OF TAX POLICY 12 (The Urban Institute, 2004); *see also* Hussey, *supra* note 4, at 438–39.

118. *See* H.R. REP. NO. 108-548, at 343 (2004) ("There is limited specific guidance with respect to common deferral arrangements. The Committee believes that it is appropriate to provide specific rules regarding whether deferral of income inclusion should be permitted."); Richard Ehrhart, *Section 409A – Treasury "Newspeak" Lost in the "Briar Patch,"* 38 J. MARSHALL L. REV. 743, 747 (2005) (suggesting that Treasury interpretations would clarify Congress's intent); *see also* Drennan, *supra* note 95, at 458 ("The legislative history of Section 409A provides almost no clues as to the rationale for its enactment.").

119. *Compare* I.R.C. § 409A (taxing compensation "at any time during a taxable year"), *with* I.R.C. § 162(m)(1) (taxing compensation that "exceeds $1,000,000").

120. *See* Drennan, *supra* note 95, at 487 ("If Section 409A discourages the deferral of compensation, it will encourage the payment of more current compensation." (footnote omitted)).

121. From the company's perspective, to the extent the shift is toward performance-based compensation, it would also be deductible to the company sooner than if the compensation were paid on a deferred basis.

negative unintended consequences, as has happened with previous changes to pay composition in response to the enactment of a tax penalty provision.[122]

Despite its brief existence, § 409A has been criticized for potentially legitimizing, rather than deterring, NQDC by standardizing and clarifying the rules governing the taxation of NQDC.[123] As a result, NQDC plans could possibly grow as companies and executives, once hesitant to structure such plans amidst uncertainty, now feel more comfortable doing so.[124] Equally as important, § 409A did not alter, but merely tightened, the already existing rules governing the taxation of NQDC.[125] Therefore, the underlying tax consequences, which arguably encourage companies and executives to agree to defer compensation, did not change.[126] This is viewed by some as problematic because that tax deferral can confer a significant tax benefit on executives.[127]

Furthermore, critics also assert that although § 409A fails to address important issues surrounding the taxation of NQDC, it creates a complex web of technical rules that will likely harm ordinary individuals who are not

122. *See* DORAN, *supra* note 117, at 2 (explaining that companies use deferred compensation to retain executive loyalty and as an incentive to increase the value of the company stock); *see also* Kathryn J. Kennedy, *A Primer on the Taxation of Executive Deferred Compensation Plans*, 35 J. MARSHALL L. REV. 487, 497 (2002) ("For the corporation, an executive deferred compensation plan permits the amount of the executive's compensation to be dependent on future performance; [and] may be used as a retention device thereby providing forfeitures for earlier departure or subsequent employment with a competitor (referred to as golden handcuffs) . . . .").

123. *See* Hussey, *supra* note 4, at 478 ("It seems that Congress may actually be encouraging nonqualified deferred compensation by enacting § 409A. With § 409A, Congress has provided a roadmap, albeit in parts confused, as to how nonqualified deferred compensation plans should be structured to avoid constructive receipt. Will this encourage more executives and employers to enter into these agreements?").

124. *Id.*

125. *See* Chason, *supra* note 95, at 360 (explaining that § 409A further restricts the application of the constructive receipt and economic benefit doctrines to executive pay, but "does not change the basic tax issues of NQDC plans"); Ehrhart, *supra* note 118, at 744 ("The law explicitly supplements, rather than supplants, existing law . . . It is clear from the plain meaning of § 409A that Congress intended to tighten the rules that govern . . . 'nonqualified deferred compensation.'"); Yale & Polsky, *supra* note 102, at 573 n.7 ("Instead, the legislation modestly strengthened the preexisting tax rules in direct response to certain abuses uncovered in the fall of Enron.").

126. *See* Chason, *supra* note 95; Daniel Halperin & Ethan Yale, *Deferred Compensation Revisited*, 114 TAX NOTES 939, 939–40 (2007); Yale & Polsky, *supra* note 102, at 586–90.

127. *See e.g.*, Chason, *supra* note 95, at 399 ("NQDC needs reform, as it allows for deferred taxation on current compensation. Executives (with the help of their employers) can shift taxation from high-tax earning years to low-tax retirement years. High-tax executives may also have the opportunity to shift investment income to their low-tax employers. Thus, the choice between payment today and payment in the future is distorted by the implicit (and potentially costly) tax benefits."); DORAN, *supra* note 117, at 1 ("But the legislation misses the mark for effective reform. It does little to address the long-standing improper tax subsidy for certain deferred compensation arrangements.").

intended targets of the legislation.[128] This is because, unlike the golden parachute provisions or § 162(m), § 409A's application is not limited to executives.[129] Indeed, subject to exceptions, § 409A applies to any taxpayer who defers compensation outside of a qualified plan, such as a 401(k).[130] Executives of large, publicly-held corporations, however, will likely have easier access to the legal assistance that is necessary to successfully navigate § 409A.

Instead of complying with § 409A, or shifting NQDC into current compensation, a third option is for executives to bargain for more control over NQDC than § 409A would permit.[131] Choosing this latter option would result in the imposition of § 409A's tax penalties, but it is unlikely that the executive would bear the financial burden of these penalties.[132] It is more likely that the executive will have a gross-up agreement in place, as was the case with the golden parachute provisions, whereby the company agrees to absorb the costs of the tax penalties.[133]

As with large golden parachutes and robust compensation packages, the Code does not prohibit NQDC plans with terms that fall outside § 409A, but makes them more costly.[134] Nonetheless, this is a consequence that companies have repeatedly shown they are willing to bear.[135]

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128. Halperin & Yale, *supra* note 126, at 939–45 ("[In light of § 409A,] [t]axpayers now face extremely complicated rules that are focused on the least important considerations and that overlook the most important.").

129. *Compare* I.R.C. § 4999 (2006), *and* I.R.C. § 162(m) (2006), *with* I.R.C. § 409A (2006).

130. *See* I.R.C. § 409A(d)(1), (3) (defining an NQDC plan as "any plan that provides for the deferral of compensation); Treas. Reg. § 1.409A-1(f) (2007) (defining service provider for purposes of § 409A); *see also* Treas. Reg. § 1.409A-2(a)(14) (excluding from § 409A's reach some situations in which it is the common practice for a service provider, such as a teacher, to receive annualized (or deferred) compensation for a period of service that comprises less than a full year); Drennan, *supra* note 4, at 26 ("[Section] 409A applies to all employers and employees that defer compensation, including closely held corporations, subchapter S corporations, partnerships, and charities."); Kopp, *supra* note 102, at 11 ("[T]he rules are a trap for the unwary and may create more problems for small employers than large publicly traded companies.").

131. *See* Drennan, *supra* note 5, at 487.

132. *See* Mullane, *supra* note 7, at 531.

133. *See* DORAN, *supra* note 117, at 13 ("[T]he power of managers to extract rents from their companies implies that, wherever possible, managers will reallocate the risk of the dispreference to the companies. They might do so, for example, through tax gross-up or indemnification clauses in their contracts providing that, should the deferred compensation arrangement be determined to violate the new rules, the companies will pay additional compensation to make the managers whole (on an after-tax basis) for any resulting tax consequences.").

134. *See supra* notes 31–32 and accompanying text; *see also* Mullane, *supra* note 7, at 531.

135. *See supra* notes 72–73 and accompanying text.

II. THE INHERENT INABILITY OF TAX PENALTIES TO CONTROL EXECUTIVE COMPENSATION

Each of the previously described tax penalty provisions was designed to discourage a particular executive compensation practice, whether it be large golden parachute payments, large annual compensation payments that are unrelated to job performance, or certain NQDC benefits.[136] However, as discussed above, each provision suffers from its own unique defects, rendering them less effective than they could be.[137] Even if attempts were made to amend the statutory design of these provisions, taxpayers could still choose to engage in the targeted conduct because the Code does not prohibit non-tax behavior; it only affects the after-tax costs.[138] Thus, as long as taxpayers are willing to pay the increased penalties, the mere ability to choose can significantly subvert the intended effect of the relevant tax penalty provision.

This ability is particularly problematic when the taxpayer is a corporation, as opposed to an individual. Although resources are not unlimited, the type of corporation that these penalty provisions target generally has the financial latitude to incur the extra costs associated with subverting the provisions, and many have chosen to do just that.[139] Corporations can also, in theory, avoid the additional costs by passing them on to consumers, shifting them to labor, or diluting them across a wide number of shareholders or capital owners, thereby undermining the deterrent effect of the penalties.[140] Furthermore, some of these corporations, for tax purposes, have net operating losses such that they do not even pay the corporate income tax.[141] If a corporation does not owe any taxes, penalizing the corporation by denying them a deduction is particularly ineffective.

The alternative of imposing tax penalties on individual executives, instead of their companies, is also ineffective because gross-up agreements and other compensation measures allow individuals to contract around the penalties.[142] In this way, though the executive avoids bearing the financial burden of the penalties, his or her avoidance increases the company's compensation costs. But, again, companies have not hesitated in shouldering those additional costs.[143] The lack of hesitation could be attributed to a variety of factors,

136. *See supra* Part I.A–C.

137. *See supra* Part I.A–C.

138. *See supra* notes 31–32 and accompanying text.

139. These companies can also generally afford to hire the best tax planners and advisers.

140. *See* Mullane, *supra* note 7, at 534–48.

141. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-957, TAX ADMINISTRATION: COMPARISON OF THE REPORTED TAX LIABILITIES OF FOREIGN—AND U.S.—CONTROLLED CORPORATIONS, 1998–2005 7 fig.1 (2008) (finding that many foreign and domestic corporations doing business in the United States reported zero tax liability from 1998 through 2005).

142. *See supra* notes 56–62, 84–89, 93–95, 133–134 and accompanying text (describing the different measures available to executives that render tax penalties ineffective).

143. *See supra* notes 59–60, 100 and accompanying text.

including the fact that ultimately these costs are not borne by the company.[144] A company, after all, is not a natural person, and only natural persons can bear financial burdens.[145] Instead, these costs are passed on to a wide array of individuals who are not the intended targets of the tax penalties, thus making the burden of these penalties inequitable.[146]

Despite missing their target, the executive compensation tax penalty provisions have nevertheless altered corporate and executive behavior, though probably not in the way Congress envisioned.[147] Moreover, reaction to these provisions has unintentionally led to other undesirable consequences.[148] Thus, these provisions are also inefficient.

In the end, the utility of the tax code is limited, as it relies substantially on its ability to affect the after-tax cost of a transaction.[149] Although each of the executive compensation penalty provisions is superficially different, they fundamentally operate in the same manner. In each instance, the relevant provision affects the after-tax cost of engaging in the targeted conduct by either: (1) denying a deduction to a company for the compensation it pays or (2) imposing additional taxes on the compensation an executive receives.[150] Such effective cost increases fit into the overall scheme of the tax system. Nevertheless, that result is ineffective if the parties are exempt from, or indifferent to, the augmented cost. Although the penalties may have deterred some companies, many others have continued to engage in these targeted practices or have otherwise maneuvered around the penalties to achieve roughly the same ends.[151]

Tax penalties on executive compensation are therefore ineffective, inefficient, and inequitable.[152] They are thus an inappropriate policy tool for

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144. Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know*, 1–2 (Nat'l Bureau of Econ. Research, Working Paper No. 11686, 2005).

145. *Id.* at 2 (stating that "only individuals can bear the burden of taxation"); *accord* ANDREW B. LYON, CRACKING THE CODE: MAKING SENSE OF THE CORPORATE ALTERNATIVE MINIMUM TAX 49 (1997) ("Clearly only people can ultimately bear the burden of the corporate tax . . . ."); Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1101 (2000) ("[C]orporate entities do not bear the economic burden of the corporate tax because only natural persons can bear economic burdens.").

146. *See* Mullane, *supra* note 7, at 534–48 (explaining that tax penalties on executive compensation are inequitable because the burden often falls on rank-and-file Americans instead of rich executives).

147. *See supra* notes 55, 59–60, 83, 86–87, 133 and accompanying text (giving examples of ways that corporate and executive behavior respond to the tax penalty provisions).

148. *See supra* notes 60–63, 92, 133 and accompanying text.

149. *See* Mullane, *supra* note 7, at 489–90.

150. *Id.* at 493–94.

151. *See supra* text accompanying notes 60–63, 67.

152. *See* Michael Doran, *Time to Start Over on Deferred Compensation*, 28 VA. TAX REV. 223, 227 (2008) (evaluating the inequity of cost-bearing on shareholders under § 409A); Hartmann, *supra* note 4, at 181 (discussing Congress's change of the incentive program to regulate corporate behavior regarding takeovers); Zelinsky, *supra* note 4, at 141 (defining the

regulating executive compensation. So, why does Congress continue to propose and enact such tax penalties?

III. CONSIDERATION OF THE POSSIBLE JUSTIFICATIONS FOR TAX PENALTIES ON EXECUTIVE COMPENSATION

Some legal scholars discuss legislation as serving an instrumental, expressive, or symbolic function.[153] Both instrumental and expressive legislation aim to affect behavior.[154] Instrumental legislation does so by altering an actor's cost-benefit analysis.[155] Alternatively, expressive legislation influences behavior by making a formal statement about behavioral

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multiple interpretations and perspectives regarding golden parachutes); Zolt, *supra* note 8, at 355 (noting the bright-line punishments of golden parachute provisions, which have a minimal relation to the actual harm). To be clear, this does not necessarily mean that *all* tax penalty provisions are ineffective, inefficient, and inequitable. This Article is limited to assessing their application to executive compensation. However, tax penalties aiming to shape non-tax behavior have been criticized more generally:

> [T]ax penalties are remarkably crude policy instruments. Although tax penalty provisions succeed in increasing the after-tax cost of the activity, they fail to increase the cost in a manner sufficiently related to the harm caused by the activity. On economic grounds, the case for tax penalties is shaky at best. Tax penalties may also be inequitable in that they treat offenders in a disparate fashion. The current tax system imposes tax penalties for some offenses, but not for others. Those offenders with high marginal rates bear greater dollar costs from tax penalties than offenders in lower tax brackets or offenders not subject to the tax system. Because the cost of tax penalties often depends on factors that bear no relationship to the harm caused or the offender's culpability, little proportionality exists between the penalty and the severity of the offense.

Zolt, *supra* note 8, at 344–45 (suggesting also that there are justifications for using tax penalties, such as lower costs of administration and serving a symbolic function).

153. *See, e.g.*, Sara Sun Beale, *Federalizing Hate Crimes: Symbolic Politics, Expressive Law, or Tool for Criminal Enforcement?*, 80 B.U. L. REV. 1227, 1254, 1264 (2000) (assessing expressive and symbolic effects of federal hate crimes legislation); Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 IOWA L. REV. 863, 869 (2004) (assessing the instrumental, expressive, and symbolic effects of alternative sanctions for tax code abuses); Mark Tushnet & Larry Yackle, *Symbolic Statutes and Real Laws: The Pathologies of the Antiterrorism and Effective Death Penalty Act and the Prison Litigation Reform Act*, 47 DUKE L.J. 1, 4 (1997) (assessing the instrumental, expressive, and symbolic effects of certain enacted legislation). These three categories are not necessarily sharply distinguishable. Moreover, it is not always easy or even possible to categorize a particular piece of legislation because "[e]very statute is likely to contain a mix of instrumental, expressive, and symbolic content." *Id.* at 76. Note also that, although closely related, examining the function of legislation is a different line of inquiry than consideration of the democratic processes behind the enactment of legislation, which might instead invoke discussions of pluralism or public choice theory, among other schools of thought, none of which are germane to the purposes of this Article.

154. *See* Beale, *supra* note 153, at 1270–71; Kirsch, *supra* note 153, at 893–94; Tushnet & Yackle, *supra* note 153, at 81–82.

155. Tushnet & Yackle, *supra* note 153, at 74.

expectations.[156] Symbolic legislation, on the other hand, is enacted to respond to public outcries for legislative action concerning a perceived problem, but does not try to significantly change the status quo.[157]

Congress's goal in enacting the various tax penalties on executive compensation was to alter corporate and executive behavior through legislation.[158] This section examines these provisions from an instrumental and expressive perspective. It reveals that tax penalties on executive compensation do not have a meaningful instrumental or expressive effect.[159] Therefore, Congress's attempt to alter executive behavior is not furthered by continued enactment of these types of tax provisions.

A. Executive Compensation Tax Penalties as Instrumental Legislation

Purely instrumental legislation does not attempt to transform belief systems.[160] Yet, it does seek to change an actor's behavior by altering the costs and benefits associated with a particular course of action.[161] It follows, then, that all tax penalties and tax incentives can be viewed as instrumental legislation.[162] As previously discussed, both tax penalties and incentives alter the after-tax cost of engaging in certain non-tax activities with the aim of encouraging or discouraging the targeted activity.[163] Stated differently, they aim to change taxpayer behavior by manipulating the taxpayer's cost-benefit analysis and thereby the decisional outcome.

The executive compensation tax penalty provisions in particular are designed to increase costs for companies offering or executives receiving certain types or levels of compensation.[164] Thus, these provisions could certainly be categorized as instrumental. However, they have largely been

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156. *Id.* at 74–75; *see also* Kirsch, *supra* note 153, at 893, 913 (discussing how instrumental and expressive laws affect social norms).

157. *See* Murray Edelman, *Symbols and Political Quiescence*, 54 AM. POL. SCI. REV. 695, 699 (1960) (advancing a symbolic legislation theory); Steve R. Johnson, *The Dangers of Symbolic Legislation: Perceptions and Realities of the New Burden-Of-Proof Rules*, 84 IOWA L. REV. 413, 445–46 (1999) (noting that with the 1998 burden-of-proof rules "Congress has protected taxpayers by giving them something which can only bark"); *see also* Bryan T. Camp, *Tax Administration as Inquisitorial Process and the Partial Paradigm Shift in the IRS Restructuring and Reform Act of 1998*, 56 FLA. L. REV. 1, 131 (2004) (critiquing the Revenue Restructuring and Reform Act of 1998 and noting that "it may well be that the statute's protection is more symbolic than real").

158. *Mullane, supra* note 7, at 489–91.

159. *See infra* text accompanying notes 162–63.

160. *See* Tushnet & Yackle, *supra* note 153, at 77 ("[Instrumental] statutes are concerned with *behavior*, not values or attitudes.").

161. *See id.*

162. Michael Doran, *Tax Penalties and Tax Compliance*, 46 HARV. J. ON LEGIS. 111, 122 (2009) (discussing how tax penalties alter a taxpayer's behavior).

163. *See supra* text accompanying notes 13–20.

164. *See supra* text accompanying notes 13–20.

ineffective in achieving their instrumental goals as discussed in Part I.[165] Then why does Congress continue to use an ineffective means to regulate executive compensation? After a decade of reflecting on the effects of the golden parachute provisions, how did Congress reach the conclusion that § 162(m) (or later, § 409A) was proper from an instrumental perspective? Enacting legislation with the aim of having an instrumental effect seems to make little sense if companies and executives, who shift additional costs back to the company, repeatedly demonstrate that they are undeterred by increased costs.

Congress certainly could have believed that the golden parachute provisions would be instrumentally effective when they were enacted. Given that Congress had not previously attempted to regulate executive compensation through increased costs, Congress fairly could have thought such penalties would have a strong deterrent effect. However, as demonstrated, they did not.[166]

Now assume that Congress reflected on the effects of the golden parachute provisions prior to the enactment of § 162(m). Congress could have determined that these provisions were largely ineffective because they misfired.[167] In other words, Congress failed to properly identify its "targets' values and preferences with enough precision to have much effect."[168]

The erroneous assumption about the golden parachute provisions could have been that companies would value saving revenue more than retaining flexibility in negotiating golden parachute agreements with executives.[169] Learning from its prior experience, then, Congress could have concluded that § 162(m) would avoid the same ineffectual fate because it allowed for significantly more flexibility in crafting compensation packages. Where there was a lack of choice in the golden parachute arena, § 162(m)'s design created, in effect, a menu of options for compensating executives, but all within the boundaries delineated by Congress.[170] For example, compensation levels are unimpeded by § 162(m)'s penalty if the compensation is tied to performance.[171] There are also myriad ways that parties can contract for performance-based compensation, rendering that restriction quite flexible.[172]

165. *See supra* Part I.

166. *See supra* note 4.

167. Tushnet & Yackle, *supra* note 153, at 78 n.373 (describing a legislative "misfire" as "a close cousin to Justice Breyer's 'mismatch,' which he defines as 'a failure to correctly match the tool to the problem at hand.'").

168. *Id.*

169. *See supra* text accompanying notes 40–45 (describing how companies could save revenue by not agreeing to golden parachutes with payouts equal to or greater than the defined level—three times an executive's base amount).

170. *See supra* note 79 and accompanying text (describing the exceptions to § 162(m)).

171. *See supra* notes 84–89 and accompanying text.

172. *See* Mullane, *supra* note 7, at 524; *see also supra* note 91 and accompanying text.

As discussed, some companies nevertheless choose to incur the § 162(m) penalty by paying their executives more than $1,000,000 and not tying it to performance.[173] In one sense, though, § 162(m) has had a modicum of success—it did change the composition of most executive compensation packages. After § 162(m) was enacted, both performance-based compensation and NQDC became more significant components of executive compensation packages.[174] Section 162(m) did not, however, restrain compensation levels or make pay more responsive to performance.[175] Thus, the alteration or change in corporate "behavior" is a hollow one in the instrumental sense. Additionally, the change in executive compensation practices led to negative unintended consequences.[176]

Armed with the foregoing knowledge, then, it must again be questioned why Congress would enact § 409A. Perhaps the underlying rationale for this provision was that the penalty might be more effective if imposed directly on the executive.[177] But the lesson that should have been learned from the golden parachute provisions, in particular § 4999, is that executives can and do shift the burden of taxes back to the company through gross-up agreements.[178]

The golden parachute provisions and § 162(m) both should have taught Congress that restricting compensation in one area just diverts it to another, which could make things worse, not better. The golden parachute provisions may have had the effect of encouraging greater overall compensation levels.[179] Rapidly increasing executive pay levels, sometimes seemingly unrelated to performance, was one of the factors that led to the enactment of § 162(m).[180] For its part, § 162(m) encouraged performance-based pay, as well as NQDC.[181] As to the former, heavy emphasis on performance-based pay is viewed as a

173. *See supra* notes 98–100 and accompanying text.

174. *See supra* notes 90, 95 and accompanying text.

175. *See supra* notes 89–91 and accompanying text.

176. *See supra* notes 92, 102 and accompanying text (noting that performance-based compensation has shifted executives' attention to short-term profitability at the expense of long-term health, and § 162(m) has encouraged executive compensation to take the form of deferred payments, which were at the center of notable corporate scandals in the early 2000s, including Enron).

177. *See supra* text accompanying notes 113–14 (discussing that the penalty provisions of § 409A are imposed on the recipient of the deferred compensation). Imposing a penalty on the company in the form of a deduction denial like § 280G and 162(m) would make no sense because NQDC is already not deductable by the company until it is included in the executive's income. Carter G. Bishop & Marian McMahon Durkin, *Nongranted Deferred Compensation Plans: A Review and Critique*, 17 WM. MITCHELL L. REV. 43, 54 (1991).

178. *See* Mullane, *supra* note 7, at 517–18 (discussing gross-up compensation); *see also supra* text accompanying notes 59–63.

179. *See supra* text accompanying notes 56–57 (finding that increasing an executive's base compensation is one way to subvert the 2.99 times base limit). Section 162(m) also had this same result. *See supra* text accompanying notes 89–91.

180. *See supra* text accompanying note 76.

181. *See supra* notes 90, 94–95 and accompanying text.

significant contributor to the aforementioned accounting and other corporate scandals.[182] With regard to the latter, receiving a greater proportion of one's pay in the distant future, in the form of NQDC, naturally led to executives negotiating terms to secure that pay as well as make it more accessible.[183] Those practices are precisely what Congress was targeting with §409A.[184] The reaction to § 409A, in turn, very well might be a reemphasis on performance-based pay or current pay unrelated to performance. The consequences of another shift in pay composition are as of yet unknown, but certainly could be negative.

In any event, Congress has miscalculated the executive compensation cost-benefit effect. Some companies and executives maneuver around the penalties in such a way as to frustrate the provisions' purposes.[185] Many others willingly choose to incur the penalties, having decided that it is to their net benefit to contract for contrary compensation packages.[186]

In sum, tax penalties on executive compensation do not serve an effective instrumental purpose.[187] The question then becomes whether these provisions serve some other meaningful purpose.

B. Executive Compensation Tax Penalties as Expressive Legislation

An emerging area of legal scholarship has been focused on how law may affect behavior in ways beyond tinkering with an actor's cost-benefit calculation.[188] Some believe that law can serve an expressive function, affecting behavior "by what it says in addition to what it does."[189] Exactly

182. *See supra* note 92 and accompanying text.

183. *See supra* text accompanying notes 109–110.

184. *See supra* note 111 and accompanying text.

185. *See supra* note 57–63, 89–91 and accompanying text.

186. *See supra* note 98–100 and accompanying text.

187. *See* Mullane, *supra* note 7, at 495.

188. *See e.g.*, Sandeep Gopalan, *Say on Pay and the SEC Disclosure Rules: Expressive Law and CEO Compensation*, 35 PEPP. L. REV. 207, 214 (2008) ("The rich vein of inquiry unearthed by scholars working on social norms theories has produced a welter of provocative writings on the expressive functions of the law."); Kirsch, *supra* note 153, at 913 ("A considerable body of recent legal scholarship addresses the expressive function of legislation."). This Article is not intended to provide an in depth history or analysis of this rich area of scholarship. For an excellent primer on the development of expressive law scholarship, see generally Alex Geisinger, *A Belief Change Theory of Expressive Law*, 88 IOWA L. REV. 35, 38–41 (2002) (explaining that traditional scholars of law and economics have generally been committed to the notion that law affects opportunity through rational choice, but the express function of law looks at the ability of law to reflect the social meaning of a particular act).

189. *See* Richard H. McAdams, *A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649, 1651 (2000); *see also* Kirsch, *supra* note 153, at 913 ("[A] statute reflects expressive functions if it is intended to change its target's conduct not by increasing the cost of engaging in undesirable behavior, but by altering social norms. This alteration in social norms may affect the target's behavior by causing him to internalize the new norm, changing his preferences, or in some other way."); Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV.

how the expressive function of law operates to alter behavior is still a very open line of inquiry.[190] This is so partly because this area of study is in its relative infancy, and partly because there is more than one way in which expressive law can alter behavior.[191]

A prominent scholar in this area, Professor Richard H. McAdams, has set forth several theories on how expressive legislation might work to change an actor's behavior.[192] One theory posits that law affects behavior by creating focal points that allow individuals to coordinate their activities.[193] McAdams uses a simple introductory example to demonstrate his theory:

> A legal proclamation—"Drive on the right"—even one that carries no threat of sanctions, may cause people to drive on the right just because the proclamation makes everyone *expect* that others will drive on the right. The central issue, of course, is why a sanctionless proclamation would cause people to change their expectations of what others will do. As I will show, when people are otherwise at a loss for how to coordinate, it takes surprisingly little to guide expectations and behavior. Once expectations are changed, the coordination problem is solved: A driver who expects others to drive on the right will almost always prefer to drive on the right as well.

2021, 2022 (1996) ("Many people support law because of the statements made by law, and disagreements about law are frequently debates over the expressive content of law."); Tushnet & Yackle, *supra* note 153, at 81 ("[Expressive laws] too are designed to change their targets' behavior, but they operate by changing their targets' values and preferences rather than by changing the costs and benefits associated with the targets' existing values and preferences.").

190. *See, e.g.*, Kirsch, *supra* note 153, at 915 ("While legal scholars are in general agreement that the expressive effect of legislation can effect changes in social norms and thereby alter individuals' behavior, there is disagreement as to how and the extent to which this phenomenon occurs."); Tushnet & Yackle, *supra* note 153, at 81 ("Exactly how [expressive statutes] change values is something of a puzzle.").

191. A number of viable theories regarding how expressive law alters behavior have been put forward in the literature. *See, e.g.*, Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585, 586 (1998); Dhammika Dharmapala & Richard H. McAdams, *The Condorcet Jury Theorem and the Expressive Function of Law: A Theory of Informative Law*, 5 AM. L. & ECON. REV. 1, 2–4 (2003) (arguing that, in situations in which new information creates uncertainty, the passage of a law may cause a rational individual to update her belief about the law's subject matter); Geisinger, *supra* note 189, at 37; Richard H. McAdams, *An Attitudinal Theory of Expressive Law*, 79 OR. L. REV. 339, 340 (2000); McAdams, *supra* note 189, at 1651; Robert E. Scott, *The Limits of Behavioral Theories of Law and Social Norms*, 86 VA. L. REV. 1603, 1606–07 (2000).

192. *See* Dharmapala & McAdams, *supra* note 191; McAdams, *supra* note 191; McAdams, *supra* note 189, at 1651.

193. *See* McAdams, *supra* note 189, at 1650–51. Professor Cass R. Sunstein has discussed a similar theory in his work. *See* Sunstein, *supra* note 189, at 2024–25, 2032–33 (discussing an aspect of the expressive function of law called "norm cascades," which uses incentives to shift behavior in new directions).

> The state can thus change behavior by changing expectations; self-interest does the rest.[194]

McAdams's focal point theory explains one way in which law can be used expressively to affect behavior.[195] In the above example, the law is used to foster the adoption of a particular behavior: driving on the right side of the road. This theory works in situations where coordination is needed and a norm has not yet been established, but can also work in situations where there is an already existing norm that lawmakers would like to change.[196] In exploring the latter notion, McAdams uses a public smoking example to demonstrate how laws can be used to change a prevailing norm.[197]

Simplifying McAdams's example, imagine a time when smoking is prevalent and non-smoking regulations are nonexistent.[198] In this context, non-smokers remain quiescent in the vicinity of smokers.[199] Next, assume a law is enacted creating non-smoking areas in airports. That act creates a competing focal point to that of smokers, as non-smokers will begin congregating in the designated non-smoking areas. Over time, non-smokers develop a voice and a presence, empowering them to enforce the no-smoking rules against would-be smokers. Eventually, the social norm in the airport, as well as other public places, could become non-smoking rather than smoking.[200] In this way, the law has changed the behavior of smokers and nonsmokers regardless of the presence or absence of formal sanctions.

Another of McAdams's theories—referred to as an attitudinal theory of expressive law—suggests "that law changes behavior by signaling the underlying attitudes of a community or society."[201] There are three premises underlying this theory. First, it assumes that individuals often strive to behave in ways that will elicit approval from others.[202] Second, it claims that individuals often fail to ascertain what kinds of acts will garner such

194. *See* McAdams, *supra* note 189, at 1652.

195. *Id.* at 1651.

196. *See id.* at 1652–53 ("Independent of sanctions, law can both cause individuals to converge on a particular convention more quickly than they otherwise would *and upset the conventions that have already emerged.*") (emphasis added).

197. *See id.* at 1714–22.

198. *See id.* Throughout his paper, and in the public smoking example, McAdams relies on a number of game theory concepts in his analysis. *Id.* at 1654 ("[A]lthough I rely on numerous game theory concepts, my analysis is mostly informal.").

199. *See id.* at 1714 ("Each player[, smokers and nonsmokers,] wants to 'get his way'—by smoking or preventing the other from smoking—but each also wants to avoid an embarrassing 'scene' that occurs when both players insist on getting their way.").

200. *See id.* at 1720.

201. McAdams, *supra* note 191, at 340.

202. *See id.* ("First, there is a motivational assumption that an individual's behavior depends, in part, on what actions she believes others will approve or disapprove. The motivating power of approval may arise because the individual values approval for its own sake, or as an instrument for achieving some other end.").

approval.[203] Third, it posits that laws can signal or reveal to individuals whether others will likely approve or disapprove particular conduct.[204] "Because people are motivated to gain approval and avoid disapproval, the information signaled by legislation and other law affects their behavior," independent of the presence of a formal sanction.[205]

In the end, McAdams's and other scholars' theories on the expressive function of the law appear to coalesce around two main ideas.[206] First, given the right conditions, the law may genuinely alter individual preferences and thereby alter their behavior.[207] Second, the law may alter behavior, although individual preferences for acting a certain way may remain unchanged, by

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203. *See id.* ("Second, there is a claim that individuals have imperfect information about what others approve and that their beliefs about such matters are frequently (though not inevitably) mistaken. Given their concern for approval, individuals are therefore sensitive to new sources of information.").

204. *See id.* ("Third, there is a claim that democratically produced legislative outcomes are positively correlated with popular attitudes and therefore provide a signal of those attitudes. Independent of the sanction, the legislative signal influences behavior by causing people to update their prior beliefs about what others approve and disapprove.").

205. *Id.*; *see also* Tushnet & Yackle, *supra* note 153, at 81 ("Some targets may wish to conform their behavior to what a majority of the population desires, but may simply be ignorant of what that is. An expressive statute may serve as a public statement of the majority's values, thereby clarifying the situation for these otherwise clueless targets. . . . An expressive statute, then, is a means of public education."). This is also similar to a theory discussed by Professor Sunstein, who has noted that the expressive function of the law can be one of public education and that such laws may "signal[] appropriate behavior" and lead their targets to believe correctly that failure to act in the indicated way will subject them to criticism by others. *See* Sunstein, *supra* note 189, at 2032.

206. *See supra* note 189; *see also* Michael Ashley Stein, *Under The Empirical Radar: An Initial Expressive Law Analysis of the ADA*, 90 VA. L. REV. 1151, 1173 (2004) ("When designed appropriately, law can cause individuals to alter their own behavior because either the law induces them to change their tastes (internalization), or creates a fear of bearing social sanctions (second order sanctions), or because of pressure brought to bear upon them through societal sanction (third order sanctions)."). One expressive law scholar, by way of the common example of a statute banning public smoking, has succinctly illustrated the main theories on the expressive function of law as follows:

> The effect of this statute on Marlboro Man, an exuberant smoker, can be threefold. Passage of the anti-smoking ordinance can (1) educate Marlboro Man that smoking really is a bad activity in which to engage, not only for himself, but also for fellow citizens within reach of second-hand smoke and for animals who may choke on cigarette butts, and so change his desire to smoke; or (2) have no affect at all on Marlboro Man's personal desire to smoke, but result in fear of social condemnation from others who witness his public smoking causing him either to curb his addiction or to practice it in private; and/or, in combination with either or both of the previous two possibilities, (3) cause other members of Marlboro Man's society to bear social pressure and condemnation upon him until he abstains from public smoking.

Id. at 1174.

207. *See* McAdams, *supra* note 189, at 1682. For example, drivers will prefer to, and will, drive on the right.

creating "a fear of bearing social sanctions." [208] In other words, individuals would be ashamed to behave in ways that society disapproves of, even if that is what they personally would prefer.

In light of these theories, it would be proper to ask whether the tax penalties on executive compensation could have been enacted to serve an expressive function. Could Congress have enacted these provisions in an attempt to change corporate and executive behavior by altering social norms surrounding that behavior? Perhaps; however, if that was the intent, it has yet to come to fruition, as corporations have continued to lavishly compensate their executives despite these tax penalties.[209]

When each of the executive compensation tax penalty provisions was enacted, Congress claimed it wanted to upset the relevant emerging pay convention and affect corporate and executive behavior in some way.[210] Perhaps Congress believed that the executive compensation tax penalties could serve an expressive function in addition to, or instead of, an instrumental one. Perhaps the message of societal distaste embedded in the instrumental sanction could cause a norm shift in executive compensation, much like McAdams's example showing a norm shift from smoking to non-smoking in public airports.

With the golden parachute provisions, the hoped-for effect could have been, for example, a shift in the takeover environment from one in which exorbitant golden parachutes are used as an antitakeover measure to an environment where more reasonable golden parachutes are used merely to provide a safety net for the executive in the event of a takeover. The law, here, could have had a coordinating effect. Instead of a race to the bottom (or, more appropriately, to the top of the pay scale), the golden parachute provisions could have coordinated corporate and executive pay expectations so that a golden parachute would be 2.99 times base salary and no more, analogizing to the scenario in which everyone would drive on the right. It could also have created a different kind of coordinating solution, or "focal point," that empowered interested groups, such as institutional investors, to develop a stronger voice in pay matters.[211]

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208. Alex Geisinger & Michael Ashley Stein, *A Theory of Expressive International Law*, 60 VAND. L. REV. 77, 84 (2007) (explaining that an aptly drafted law can change human behavior by taking into account the connection between law, norms, and the significance of certain social behaviors).

209. *See* Conway, *supra* note 4, at 410 (noting that § 162(m) was ineffective and instead of curbing executive pay, companies responded to the legislation by paying their executives in stock rather than cash); Drennan, *supra* note 4, at 10–15 (providing examples of valuable stock options, severance packages, and fringe benefits given to executives even after legislation was passed).

210. *See supra* Part I.A–C.

211. *See* McAdams, *supra* note 189, at 1659 (explaining that focal points are special solutions that appeal to many people and help with coordinating reactions to problems).

Parallel suppositions can be made in the contexts of §§ 162(m) and 409A. Section 162(m) could have caused a norm shift from widely variant executive pay levels, seemingly unconnected to performance, to a corporate world where pay is correlated with performance and executives otherwise make no more than $1,000,000. Section 409A likewise could create a shift by eliminating variation and standardizing NQDC practices.

The problem with various aspects of the focal point theory is that corporate and executive self-interests are not served by coordinating and conforming pay practices.[212] Unlike the rules-of-the-road example, in which failure to drive on the right side could lead to injury or worse, abiding by the legislatively preferred executive pay practices would likely leave an executive earning less than peers who are paid by companies that choose to absorb any penalties and to continue to compensate handsomely.[213] This is due in large part to the culture surrounding executive pay, where each executive aims to make more than fifty to seventy-five percent of his peers, reflecting his or her above average worth to the company.[214] In other words, everyone is competing to be one of the more highly compensated executives in his or her peer group. Similarly, companies offer competitive compensation packages to attract and retain the best executive talent they can find.[215]

In the end, executive compensation does not present an issue of coordination. Viewed from the perspective of McAdams's attitudinal theory, the executive compensation tax penalties should have at least sent a clear signal about society's disapproval of the relevant pay practice, be it lucrative golden parachutes, exorbitant overall compensation levels unrelated to performance, or robust executive deferred compensation perquisites.[216] Each of the tax penalty provisions was enacted amidst significant, negative popular

212. *See id.* (explaining that to coordinate solutions, the parties must be amenable to the same course of action).

213. *See, e.g.*, Lublin & Thurm, *supra* note 60 (pointing out that many companies ignore caps on executive pay, opting to take the tax penalties).

214. *See, e.g.*, Eugene Kandel, *In Search of Reasonable Executive Compensation*, 55 CESIFO ECON. STUD. 405, 412 (2009) ("After all, no board wants to admit that their chosen CEO is of lower quality than the average, thus her compensation must be above the average as well, which drives the average forever higher."); Jeff May, *Peer Pressure Pays: Rising Compensation is Tied to Competition*, STAR-LEDGER, June 1, 2008, at 1 ("Besides choosing inappropriate peers, some companies set pay targets at the high end of the comparison group, such as the 75th percentile."); Gretchen Morgenson, *Peer Pressure: Inflating Executive Pay*, N.Y. TIMES, Nov. 26, 2006, § 3, at 8 (explaining how companies will define peer groups so that their executives are in the fiftieth to seventy-fifth percentile range).

215. *See* Kandel, *supra* note 214, at 408, 412 ("[P]ressure from the market for managers forces firms to develop the optimal compensation strategies, because otherwise they fail to attract talented managers. . . .'We must pay the market rates to attract and retain the necessary talent' is a sentence frequently used.").

216. *See* McAdams, *supra* note 191, at 340 (positing that democratically produced legislation will reflect and signal popular attitudes).

sentiment toward executive pay.[217] In theory, these provisions would have conveyed to corporations the widespread public disapproval of the targeted executive pay practices. That message would, in turn, shame companies and their executives to conform those pay practices in accordance with the parameters set forth in the relevant tax provision. Although adjustment occurred, shame was not the motivating part of the equation.

To some extent, many companies and their executives did adjust their pay practices as a result of the penalty provisions. In the case of each provision, commentators have noted their legitimizing effect.[218] Recall for example that one effect of § 162(m) was that many executives immediately got a pay raise to $1,000,000.[219] Section 280G had a similar legitimizing effect, as is predicted for § 409A as well.[220] A message was, therefore, received.

However, the executive compensation tax penalty provisions were not enacted to endorse and encourage greater compensation levels and benefits than executives were previously receiving. Rather, these provisions were enacted to restrain and constrain.[221] They did, however, have some measure of an endorsement effect.[222] To an extent, this makes sense, as the provisions outline where the line is drawn as to what is acceptable and what is not.[223] It is thus somewhat predictable that many would react by, at a minimum, positioning themselves at that line. This is what is referred to above as the legitimizing effect of these provisions.[224]

Nonetheless, the executive compensation tax penalty provisions send a clear message of disapproval with regard to compensation and benefits beyond the limits authorized, and seemingly endorsed, by Congress. Outside the parameters of the particular provision, a tax penalty is imposed that increases the effective cost of the compensation.[225] That is a strong indicator of disapproval.

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217. *See* Mullane, *supra* note 7, at 513–14, 519–20, 526.

218. *See supra* notes 55, 84 and accompanying text.

219. *See supra* note 84 and accompanying text.

220. *See supra* note 56 and accompanying text.

221. *See supra* Part I.A–C (describing Congress's goal to be one of deterrence when they enacted the restrictive legislation); *see also* Byrne, *supra* note 83, at 1 (noting that Congress did not intend to set a "minimum wage" of $1,000,000 for CEOs; instead, it aimed to put the brakes on intemperate remuneration).

222. *See supra* notes 55, 84 and accompanying text.

223. *See* I.R.C. § 162(m) (2006) (limiting deductions, subject to exceptions, to $1,000,000 for compensation paid to top executives); I.R.C. § 280G (stating there is no deduction for excess parachute payments, and then defining excess parachute payments); I.R.C. § 409A (governing the receipt of compensation through NQDC plans); I.R.C. § 4999(a)–(b) (imposing a twenty percent tax on excess parachute payments, and defining excess parachute payments according to § 280G).

224. *See supra* notes 218–220 and accompanying text.

225. *See* I.R.C. § 162(m) (denying a deduction for certain remuneration that exceeds $1,000,000); I.R.C. § 280G(a) (penalizing excess parachute payments by denying a deduction); I.R.C. § 4999(a) (imposing a twenty percent tax on excess parachute payments).

Nevertheless, at many companies, the targeted executive pay practices continued unabated.[226] Others altered their practices, but in a way that did not lead to any meaningful change.[227] Commentators predicted these results prior to the enactment of the golden parachute provisions.[228] Despite such predictions, it could have made sense for Congress to give the golden parachute tax penalties a chance to have a significant impact. When it became clear, however, that many companies and their executives were not shamed into conforming their golden parachute agreements to fall within the limit set by § 280G, Congress would have had to rethink the utility of using the Code to make a statement about executive pay practices.

Congress did not learn its lesson, though. Instead, it subsequently enacted § 162(m). That provision should have signaled to corporations and executives that Americans disapprove of pay in excess of $1,000,000 unless it is tied to performance. Once again, that message has failed to fully resonate with and shame executives and their companies into behaving differently or in an approved way.[229] Many companies continue to pay executives more than $1,000,000 regardless of performance.[230] Even when companies have increased the share of executive pay that is performance-based within the meaning of § 162(m), executives appear to experience only the benefits of good performance and do not suffer for bad performance.[231] Of note, though,

226. *See* Conway, *supra* note 4, at 424–25.

227. *Id.* at 419–22.

228. *See generally* Mullane, *supra* note 7, at 519 (asserting that it was apparent at the time the golden parachute provisions were enacted that they would be ineffective). As one commentator noted, "Congress has, as usual, made an opening move in a corporate chess game and neglected to consider its opponents' countermoves." Graef S. Crystal, *Manager's Journal: Congress Thinks It Knows Best About Executive Compensation*, WALL ST. J., July 30, 1984, at 16. Shortly after enactment of the two provisions, other commentators hypothesized that indemnification provisions in executive contracts would arrange for the corporation to bear the twenty percent excise tax. *See* Edwin T. Hood & John J. Benge, *Golden Parachute Agreements: Reasonable Compensation or Disguised Bribery?*, 53 UMKC L. REV. 199, 213–14 (1985) (assessing effects of § 280G and § 4999 and referring to provisions as "rather draconian").

229. *See generally* Conway, *supra* note 4, at 410–14 (analyzing how corporations and executives found a way around Congress's intent behind § 162(m)).

230. *See supra* notes 98–100 and accompanying text.

231. *See, e.g.*, Steven A. Bank, *Devaluing Reform: The Derivatives Market and Executive Compensation*, 7 DEPAUL BUS. L.J. 301, 312 (1995) ("[S]tock options . . . carry no downside risk for the executive."); Linda J. Barris, *The Overcompensation Problem: A Collective Approach To Controlling Executive Pay*, 68 IND. L.J. 59, 66 (1992) ("Many compensation packages are constructed so that the executive profits in good times and is protected in bad. If stock prices decline, the executive may lose his bonus, but he may have the ability to renegotiate the option portion of his existing plan to lower the strike price, the price at which the option can be exercised. Thus, the executive is rewarded regardless of his or the corporation's performance and is simultaneously insulated from the ravages suffered by fellow shareholders if stock value declines."); Susan J. Stabile, *Viewing Corporate Executive Compensation Through a Partnership Lens: A Tool To Focus Reform*, 35 WAKE FOREST L. REV. 153, 216 (2000) (criticizing option repricing as insulating executives from losses, while allowing them to reap the benefit of gains);

is that the shift in emphasis to performance-based pay generally led to increased overall compensation levels.[232]

If Congress was seeking to enact expressive legislation, then the evidence indicating that executive compensation tax penalty provisions were failing to have an expressive effect should have resonated with Congress prior to enacting subsequent provisions. Apparently, it did not. It could be said, though, that it is nevertheless good for Congress to continue to signal disapproval through legislation, even if that message is not internalized by many of the targeted companies and their executives. As already mentioned, though, each of these provisions has generated negative unintended consequences.[233] As Professor Sunstein has written: "If legal statements produce bad consequences, they should not be enacted even if they seem reasonable or noble."[234]

IV. CONCLUSION

Tax penalties on executive compensation have not been instrumentally or expressively effective. To the extent these penalties have affected corporate and executive behavior, they have not done so in a way that generates enough, if any, positive returns. However, the negative unintended consequences of these penalties have been abundant.

Put simply, tax penalties are not a good tool for trying to regulate executive compensation practices. Yet, Congress has continued to enact, or propose enactment of, this type of regulation. However, this Article shows that it is no longer reasonable, and has not been for some time, for Congress to consider tax penalties an effective vehicle for enacting instrumental or expressive legislation regulating executive compensation.

If Congress wants to enact effective legislation to regulate executive compensation, then it needs to learn and accept that tax penalties are not the way to achieve those ends. From there, Congress could begin serious consideration of alternate solutions.[235] One of the first assessments that

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Linda Barrett, Note, *Unsharing the Wealth: Recent Economic Volatility Has Greatly Impacted Executive Compensation*, 54 RUTGERS L. REV. 293, 319–20 (2001) (opining that option repricing not only allows executives to reward themselves when the company's performance is poor, but also provides them little incentive to fix the source of the problem that led to the poor performance); Alison Leigh Cowan, *Mom, Apple Pie and Stock Options?*, N.Y. TIMES, Mar. 6, 1994, at C15. *But cf.* Richard A. Booth, *Executive Compensation, Corporate Governance, and the Partner-Manager*, 2005 U. ILL. L. REV. 269, 283–84 (asserting that repricing may serve valid business purposes).

232. *See supra* notes 90–91 and accompanying text.

233. *See supra* text accompanying notes 36–37.

234. *See* Sunstein, *supra* note 189, at 2025.

235. This discussion proceeds from the assumption that Congress wants to regulate executive compensation, and does not consider whether Congress should be, or to what extent, engaged in such regulation.

Congress should then make is whether other Code-based solutions could be workable, or if instead Congress should look outside of the Code.

It is not likely that a Code-based approach to regulating executive compensation would be workable. This Article has already discussed some of the problems with using tax penalties to discourage executive compensation practices. The reverse, tax incentives to encourage desirable compensation practices, is likely also not workable. Although further research is needed regarding that option, executive compensation tax incentives are likely to suffer from similar weaknesses as tax penalties. Corporations and executives can choose to forego the incentive, or to comply to receive the incentive and then find another way to achieve their overall compensation goals. Thus, in the end, there is likely no positive role for the Code to play in regulating executive compensation.

It seems much more plausible that direct non-tax regulation would be effective. For example, Congress could, in theory, mandate that companies pay their executives no more than a certain amount. Such direct regulation certainly would achieve the goal of ensuring that executives are not paid above a specified amount. However, such direct legislation is not as easily enacted as tax penalty legislation. Americans tend to recoil at such interference in personal contracting, and it also offends their laissez-faire sensibilities. Nevertheless, limitations of this type on executive compensation were recently enacted to apply to organizations participating in the TARP program.[236] This shows it is not impossible to enact direct non-tax limitations, but it is not likely that the TARP limits will be extended beyond the reach of those participating in the TARP program to companies more generally.

Another option is imposing direct fine or penalties on either the company or the executive. This path might be slightly less offensive to many strongly held American ideals than imposing a cap. Even so, it is probably not a good option. The economic incidence of those penalties is likely to be shifted off of the company or executive and onto others whom the fines and penalties were not meant to penalize.[237]

Congress can and should also consider less direct non-tax approaches, such as measures to strengthen corporate governance structures. In reaction to the recent financial crisis, Congress did take steps in that direction with the say-on-pay provision[238] and other measures enacted in the Dodd-Frank Act.[239] Arguably, though, these measures were modest and Congress could explore doing more.

236. Kathryn J. Kennedy, *Excessive Executive Compensation: Prior Attempts to Curb Perceived Abuses*, 2 HOUS. BUS. & TAX L.J. 196, 241–53 (2010) (describing the limitations applicable to TARP recipients).

237. *See* Mullane, *supra* note 7, *passim*.

238. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376 (2010).

239. *See id.*

Perhaps, though, Congress is not seriously interested in effectively altering corporate and executive behavior. Tax legislation attempting to regulate executive compensation could be just symbolic. In other words, the legislation "serves the needs of the public by indicating that Congress is 'doing something' about a perceived problem," while actually doing nothing.[240] But, the executive compensation tax penalties do not "do nothing." They have attendant negative consequences.[241]

240. *See* Kirsch, *supra* note 153, at 921.

241. *See supra* text accompanying notes 36–37. These negative consequences likely can only be remedied by repeal of the tax penalty provisions. Repeal is not likely, though, for what should be fairly obvious political reasons. No one in Congress wants to be cast, rightly or wrongly, as championing executives and what likely would be framed as helping companies to pay their executives more handsomely at taxpayer expense.